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REPORT  
OF THE  
ROYAL COMMISSION ON  
TAXATION  
VOLUME 6  
IMPLICATIONS OF THE  
PROPOSED TAX REFORMS  
1966

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REPORT

of the

ROYAL COMMISSION ON TAXATION

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Mr. Donald G. Grant

Mrs. S. M. (Eleanor) Milne

Mr. Chas. E. S. Walls

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CONTENTS OF THE COMPLETE REPORT

VOLUME 1 - Introduction, Acknowledgments and Minority Reports

VOLUME 2 - The Use of the Tax System to Achieve Economic and Social Objectives

VOLUME 3 - Taxation of Income:  
Part A - Taxation of Individuals and Families

VOLUME 4 - Taxation of Income: (continued)  
Part B - Taxation of Income Flowing Through Intermediaries  
Part C - Determination of Business Income  
Part D - International

VOLUME 5 - Sales Taxes and General Tax Administration:  
Part A - Sales and Excise Taxes and Duties  
Part B - General Tax Administration

VOLUME 6 - Implications of the Proposed Tax Reforms





## VOLUME 6

## C O N T E N T S

	<u>Page</u>
CHAPTER 35 - EFFECTS OF OUR PROPOSALS UPON THE REVENUE YIELD OF THE TAX SYSTEM	1
THE LONG-TERM EFFECTS OF OUR RECOMMENDATIONS ON TAX REVENUES	2
Definition of Current 1964 Taxes	3
Changes in Tax Revenue Collected at the Corporate Level	8
Changes in the Personal Income Tax Base	13
Changes in Personal Income Tax Revenue	23
Changes in Sales Tax Yields	27
ANALYSIS OF THE REVENUE EFFECT OF EACH MAJOR RECOMMENDATION	31
TRANSITIONAL EFFECTS OF OUR RECOMMENDATIONS ON TAX REVENUES	33
Short-Term and Long-Term Impacts of our Recommendations	33
Revenue Effects of Transitional Provisions	37
Alternative Approaches to the Transitional Problem	39
CONCLUSIONS	42
REFERENCES	45
CHAPTER 36 - INCIDENCE OF THE PROPOSED SYSTEM	47
INCIDENCE OF CHANGES IN DIRECT TAXES	49
Incidence for Non-Residents	50
Incidence for Typical Residents	52
Incidence by Income Class for Residents	56
Incidence by Income Class for Different Age, Occupation and Sex Groups	63
INCIDENCE OF CHANGES IN SALES TAXES	67
INCIDENCE OF ALL TAXES COMBINED	67
CONCLUSIONS	69
REFERENCES	71
CHAPTER 37 - THE ECONOMIC EFFECTS OF THE PROPOSED TAX REFORMS	73
EFFECTS ON THE QUANTITY AND QUALITY OF LABOUR EFFORT	78
Lower Marginal Rates	79
Tax Inducements to Emigrate to the United States from Canada	81
The Participation Rate for Married Women	82
Education and Training	84

	<u>Page</u>
EFFECTS ON THE ALLOCATION OF FIXED CAPITAL	86
The Efficiency of Market Allocation	87
A Programme to Improve the Allocation of Capital	90
The Importance of the Improved Allocation of Fixed Capital	93
ESTIMATES OF THE PROPOSED CORPORATION INCOME TAX CHANGES ALLOCATED BY INDUSTRY, BY TYPE OF REFORM AND BY OWNERSHIP	94
EFFECTS ON THE RATE OF SAVING AND CAPITAL FORMATION BY LARGE RESIDENT-OWNED CORPORATIONS WITH NO SPECIAL TAX CONCESSIONS	100
Effects on the After-Tax Income of Resident Shareholders	101
Effect on the Rate of Fixed Capital Formation	106
Financing an Increased Rate of Fixed Capital Formation	111
EFFECTS ON THE SAVING AND CAPITAL FORMATION OF OTHER BUSINESS	118
Effects on Large Non-Resident-Owned Corporations with No Special Tax Concessions	118
Effects on Mining and Petroleum Corporations	119
Effect on Small Corporations	125
Unincorporated Businesses Generally	127
Real Estate	128
ESTIMATES OF CHANGES IN BUSINESS SAVING	129
EFFECTS ON PERSONAL SAVING AND INVESTMENT	134
The Determinants of Personal Saving	134
The Effects of Tax Changes on the Rate of Personal Saving	137
Contractual Saving	140
Estimates of the Changes in the Rate of Personal Saving	141
Changes in the Form of Personal Saving	146
OVERALL EFFECTS ON THE RATE OF SAVING AND INVESTMENT	150
EFFECTS OF THE TAX REFORMS UPON THE BALANCE OF PAYMENTS	155
Current Account	156
Capital Flows	158
Indirect Effects	162
IMPLICATIONS FOR ECONOMIC OBJECTIVES	164
Implications for Economic Growth	165
Achieving Further Increases in the Growth Rate	166
CONCLUSIONS	169
REFERENCES	176
CHAPTER 38 - FEDERAL-PROVINCIAL IMPLICATIONS	187
PERSONAL AND CORPORATION INCOME TAXES	190
Common Income Tax Base	193
Administration of Income Taxes	194
Integration of Personal and Corporation Income Taxes	195
Harmonization of Rates of Personal and Corporation Income Taxes	197
Abolition of Death Taxes	201



SALES TAXES	202
The Scope or Coverage of the Tax	203
"Direct" or "Indirect" Retail Sales Tax	204
Constitutional Considerations	205
Interprovincial Transactions	208
Administration of a Federal-Provincial Retail Sales Tax	209
Rates of Tax	210
CONCLUSIONS AND RECOMMENDATIONS	213
REFERENCES	216
APPENDIX A - ASSUMPTIONS UNDERLYING OUR ESTIMATES OF THE REVENUE YIELD AND INCIDENCE OF CURRENT AND PROPOSED DIRECT TAXES	219
APPENDIX B - CALCULATION OF THE CHANGE WHICH WOULD OCCUR UNDER OUR PROPOSALS IN THE TAXES PAID BY SEVEN SAMPLE GROUPS OF TAXPAYERS	247
APPENDIX C - PRORATION OF THE EFFECTS ON TAX REVENUES FROM RESIDENT INDIVIDUALS OF EACH PROPOSED DIRECT TAX REFORM	263
APPENDIX D - DERIVATION OF THE 1964 SALES TAX BASE UNDER OUR PROPOSALS	275
APPENDIX E - ESTIMATE OF THE INCIDENCE OF THE PROPOSED SALES TAX AND DIRECT TAXES FOR FAMILY UNITS CLASSIFIED BY INCOME	281
INDEX	287





EFFECTS OF OUR PROPOSALS UPON THE  
REVENUE YIELD OF THE TAX SYSTEM

Our terms of reference require us to "make recommendations for improvements in the tax laws and their administration that may be consistent with the maintenance of a sufficient flow of revenue." Because our terms of reference are not explicit as to the meaning of a "sufficient flow of revenue", we have interpreted this to mean that the tax system that we propose must produce the same amount of revenue as is produced by the present system.

This approach ignores the expenditure side of the fiscal system. This condition should not be taken as indicating our views on the adequacy or inadequacy of the existing level of government expenditures, but only that, as a Royal Commission on Taxation, we were not invited to examine government expenditures. We are confident that our proposals would improve the equity of the Canadian tax system and would enable a given amount of revenue to be raised with wider public acceptance than under the existing system.

In this chapter we outline the effects of our proposals on the various tax bases and the revenue gains or losses that might be expected from each of our major recommendations. Four of the main sources of present federal tax revenues are affected by our proposals and are included in this analysis. These are the personal income tax, the corporation income tax, the sales and excise taxes, and the gift and estate taxes. We do not discuss import duties in this Report and consequently revenue from this source does not enter into our considerations.

In the long run, the implementation of our comprehensive tax base proposals would increase the total amount of assessable income 1/ included in the personal income tax base of residents by about 18 per cent, although more than half of this increase would be accounted for by including in the base undistributed corporate income and gifts and bequests, items that are to some extent currently subject to separate levies. At the same time

we propose changes that would increase the corporation tax base by almost 13 per cent. The sales tax base would be substantially increased, with almost half of the increase caused by the shifting of the tax from the manufacturer's level to the retail level.

These increases in the tax base would not all occur immediately upon implementation of our recommendations, as some of them would take effect only gradually. Therefore, in order to meet the requirement of providing sufficient revenue for the existing level of expenditure, we have recommended rates for the personal income tax and the sales tax that would provide approximately the same revenue from our proposed tax bases during the initial transitional period as would have been raised under the present tax system. Once the transitional period had ended these rates would produce significantly more revenue than the present tax system.

Consistent with our general views concerning equity, we believe that it would be desirable to reduce the weight of sales tax. Consequently, we recommend a tax on retail sales at the rate of 7 per cent, in place of the current tax on manufacturers' sales, which is imposed at the rate of 11 per cent, and certain excise taxes. This change would result in a reduction of roughly 8 per cent in the revenue from the sales and excise taxes. This loss in revenue, combined with the transitional effects of other recommendations, has caused us to recommend initial income tax rates that would, in the long run, produce an increase of approximately 7 per cent in the revenue yield of all federally imposed direct taxes. If government expenditures continued at a level that could be financed by revenue from current tax rates under the existing system, our proposals would permit significant future tax reductions.

#### THE LONG-TERM EFFECTS OF OUR RECOMMENDATIONS ON TAX REVENUES

In this section of the chapter, we examine the effects of our proposed reforms upon the revenue yield of the tax system once our proposals can be assumed to have become fully productive.



To analyze our recommendations, we have made a detailed examination of the tax revenue which would have been raised in 1964 had the system we propose been in full effect for all of that year, 1964 being the most recent year for which we could obtain sufficient data for detailed estimates 2/. The effect of growth in income upon tax revenue would likely be greater under our proposed tax system than under the current system, so that we believe that the comparisons presented in this section understate the amount of revenue which our proposals would yield when they were fully implemented.

The estimated overall effect of our proposals upon 1964 tax revenues is shown in Table 35-1. As this table indicates, our proposals would have increased tax revenues by approximately \$220 million in that year. We will subsequently show that this surplus revenue would have been sufficient to absorb the transitional revenue losses which would likely have occurred in the first few years after implementation.

In this section we will analyze the revenue yield from each tax by means of which revenue would continue to be collected under our proposals. We provide first a detailed definition of the current taxes shown in Table 35-1 and reconcile them with the actual amounts accrued in 1964. We then describe what the long-term effects of our recommendations would have been upon 1964 revenues from the corporation income tax, the personal income tax and the sales tax. The long-term revenue elasticity of the tax system is discussed in the final portion of this section.

#### Definition of Current 1964 Taxes

In the case of all income taxes, the present and proposed taxes have been calculated on an accrual basis. Furthermore the tax which would have been accrued in 1964 under the current tax system has been calculated so as to reflect the more important changes in the Income Tax Act and Excise Tax Act that were enacted between 1964 and 1966. When we refer to current "tax law" we mean the law as at December 31, 1966; accordingly, the term does not include the proposals contained in the Supplementary Budget Speech, House of Commons Debates, December 19, 1966. All changes are assumed to have been fully effective for all of 1964.

TABLE 35-1

THE EFFECT OF OUR PROPOSALS ON 1964 REVENUE  
FROM TAXES AFFECTED BY OUR REFORMS  
(millions of dollars)

	Revenue Under the Current Tax System	Revenue Under the Proposed Tax System	Change
Corporation income tax	1,941	2,473	532
Gift and estate taxes	143	—	-143
Personal income tax	2,676	2,634	- 42
Sales and excise taxes	<u>1,597</u>	<u>1,472</u>	<u>-125</u>
Total revenue from taxes affected by our reforms	<u>6,357</u>	<u>6,579</u>	<u>222</u>

Note: Revenue under the current tax system is assumed to be the same as that actually accrued in 1964 except that certain modifications in the existing tax law enacted between 1964 and 1966 have been reflected in our estimates of current revenue from the personal income tax and manufacturer's sales tax. These modifications are detailed in Tables 35-2 and 35-3. Corporation income tax includes the tax on corporate distributions to residents made under the provisions of section 105 of the Income Tax Act. Personal income tax includes an adjustment of \$50 million to reflect the deferment of tax on corporate source income attributable to the trustees of Registered Retirement Income Plans and to certain exempt institutions which are now taxed at the corporate level. All taxes include old age security taxes collected and are before abatements of tax to the provinces.

Sources: Tables 35-6, 35-13 and 35-14.

In addition to showing all taxes on an accrual basis, we have calculated their revenue yield before abatements to the provinces. All tax changes reported in this chapter consequently show the total effect of our recommendations, and not just their effect on the net receipts of the federal government.

The relationship between the personal income tax accrued in 1964 and that which would have been accrued if the subsequent amendments had been in effect is presented in Table 35-2. As the table shows, changes in the Income Tax Act that were enacted between 1964 and 1966 would have reduced the 1964 revenue yield of the personal income tax by approximately \$130 million if they had

TABLE 35-2

RECONCILIATION OF THE ACTUAL AMOUNT OF PERSONAL INCOME  
TAX REVENUE FOR 1964 TO THE REVENUE THAT WOULD HAVE  
RESULTED IN 1964 UNDER CURRENT (1966) TAX LAW  
(millions of dollars)

1964 federal income tax accruals (Note 1)		
Personal income tax		1,985
Old age security tax		<u>397</u>
		2,382
Personal income tax abated to provinces (Note 2)		<u>433</u>
Total tax on 1964 personal income under 1964 tax law		<u><u>2,815</u></u>
1964 net personal income tax base under 1964 tax law (Note 3)	13,311	
Major changes in the base between 1964 and 1966:		
Extension of old age pensions to all residents aged 65 to 69 (Note 4)	242	
Less: deduction for Canada Pension Plan premiums (Note 5)	<u>327</u>	<u>(85)</u>
1964 personal income tax base under 1966 tax law		<u><u>13,226</u></u>
Total tax on revised 1964 base at 1964 rates (Note 6)	2,779	
Revenue loss resulting from changes in tax rates (Note 7)		<u>103</u>
Total personal income tax on revised 1964 base at 1966 rates		2,676
Net reduction in personal income tax that would have resulted in 1964 if the 1964-66 changes in tax law had been in effect	128	
Sample averaging errors (Note 8)	<u>11</u>	<u>139</u>
Total tax on 1964 personal income under 1964 tax law		<u><u>2,815</u></u>

**Note:** The provisions for the extension of old age pensions have been fully taken into account even though the extension is to take effect only gradually over a period of years. For an explanation of the Notes, see Appendix A to this Volume.



been in effect for all of 1964. Most of this decrease would have resulted from reductions in rates.

The effect on tax revenues of changes in the scope of the tax base enacted between 1964 and 1966 provides an example of the need for careful, detailed analysis in assessing the impact of a combination of large and partially offsetting changes in the personal income tax base. Because of the progressiveness of personal income tax rates, the revenue effect of any change in the tax base depends very largely upon which taxpayers are affected by the change. It is consequently difficult to make accurate revenue estimates without a detailed analysis of the incidence of each change in the tax base. A net change in the total tax base need not imply that tax revenues change in the same direction. By the same token, a given net change in the tax base may result in an even larger relative change in tax revenues.

To obtain estimates of revenue effects which could be regarded as reasonably accurate, we had a set of computer programmes prepared to calculate the effect of our reforms on each of a large number of individual taxpayers and then to summarize the aggregate results of these estimates. These programmes were applied to data aggregated as described in Appendix B to this Volume from a sample of 417,000 tax returns; these returns were unidentified as to taxpayer. The sample was supplied to us on magnetic tape by the Department of National Revenue. Sampling rates governing the selection of each tax return in the sample were used to "blow up" each calculation to allow for the number of taxpayers represented by each tax return sampled  $\frac{3}{4}$ . The estimates shown in Table 35-2 were calculated in this manner.

The relationship between actual 1964 sales and excise tax revenues and the estimates presented in Table 35-1 of what the revenues would have been if the current law had been in full effect in 1964 is shown in Table 35-3. Adjustments are made to reflect the elimination of the sales tax on production machinery provided for in the 1966 legislation and to reflect the

TABLE 35-3

RECONCILIATION OF THE ACTUAL AMOUNT OF SALES AND EXCISE  
TAX REVENUE FOR 1964 TO THE REVENUE THAT WOULD HAVE  
RESULTED IN 1964 UNDER CURRENT (1966) TAX LAW  
(millions of dollars)

Actual sales and excise tax revenue in 1964		
Manufacturer's sales tax	1,500	
Excise taxes (to be eliminated under our proposals)	<u>40</u>	<u>1,540</u>
Changes in the sales tax base between 1964 and 1966:		
Removal of the tax on production machinery	(98)	
Full implementation of the tax on building materials	<u>155</u>	<u>57</u>
Adjusted 1964 sales and excise tax revenue		<u><u>1,597</u></u>

Note: The effect of the sales tax changes enacted between 1964 and 1966, if applied to 1964 and assuming full removal of the tax on production machinery, would have been to eliminate the yield on production machinery at 4 per cent for the first quarter of 1964 and 8 per cent for the last three quarters of the year; and to add the balance of a full 11 per cent yield on building materials in 1964 (7 per cent additional tax for one quarter and 3 per cent additional tax for three quarters). The actual revenue yield of the manufacturer's sales tax in fiscal 1964-65 exceeded revenue from this source in the calendar year 1964 by \$88 million; the difference is accounted for in part by the full taxation of production machinery and building materials and in part by growth in the overall base. Excise tax yields shown above for 1964 consist of yields from all excise taxes other than those on wine and tobacco.

taxation of building materials at the full 11 per cent rate of sales tax, which did not apply until January 1, 1965.

There were no major changes in the base or the rates of either the corporation income tax or the gift and estate taxes between 1964 and 1966.

#### Changes in Tax Revenue Collected at the Corporate Level

In our estimates, the tax revenue collected from corporations would be increased as the result of two types of reforms which we recommend. First, the net effect of a number of different changes in the scope of the base upon which corporation tax is levied would be to increase the base by \$560 million. Secondly, while the net effect of integrating the corporation and personal income taxes would be to reduce the taxation of corporate source income received by residents, a necessary element of integration would be the taxation of all of the corporation tax base at a uniform rate. By raising the rate of tax on the first \$35,000 of corporation tax base from 21 per cent to 50 per cent, the average rate of tax would be increased. As is shown in Table 35-6, the net effect of both changes would be to increase revenue collected at the corporate level by over half a billion dollars.

The major categories of change in the corporation tax base are shown in Table 35-4. As can be seen from the table, \$520 million would be added to the corporation tax base of a few specific industries that receive tax concessions under the current tax system which we believe to be inequitable and economically inefficient. Of this amount, \$320 million would be added to the tax base of the mining and petroleum industries and \$200 million would be added to the tax base of certain types of financial institutions, principally life insurance companies.

Apart from the specific changes for the extractive industries and for financial institutions, the net change in the corporation tax base would



TABLE 35-4

CHANGES IN THE 1964 CORPORATION TAX BASE  
(millions of dollars)

Corporation tax base under present  
law (Note 9)

Current year's profit for taxable corporations	4,634	
Less: deduction for prior year's loss	248	
		<u>4,386</u>

Additions to the corporation tax base

Elimination of percentage depletion on income derived from mining and petroleum (Note 10)	160	
Elimination of the three-year tax exemption for the income from new mines (Note 11)	160	
Elimination of the special provision defining the income of life insurance companies so that their income would be reported on a basis similar to that of other companies (Note 12)	150	
Other changes in the definition of income of financial institutions— the taxation of non-resident general insurance companies and more stringent allowances for doubtful loans for banks and mortgage lenders (Note 13)	50	
Inclusion in the tax base of capital gains and losses realized by corpo- rations (Note 14)	200	
Other increases in the tax base resulting from, among other things, a reduction of tax avoidance (Note 15), less an estimate of the effect of the accelerated capital cost allowance for new and small incorporated businesses (Note 16)	40	
		<u>760</u>

Deductions from the corporation tax base

Extension of the period of loss carry- over to two years back and an unlimited carry-forward (Note 17)	200	<u>560</u>
Corporation tax base under our proposals		<u><u>4,946</u></u>

Note: For an explanation of the Notes, see Appendix A to this Volume.

amount to only \$40 million. However, this would be the net result of several substantial offsetting changes. Each of the offsetting changes would affect different corporations in different ways. The effect on corporate investment of these and other changes in the taxation of corporate source income is discussed in Chapter 37.

The total corporate source income which would have been included in the comprehensive tax base of resident individuals in 1964 is shown in Table 35-5. Because of the variation in ownership patterns in different industries, the portion of the proposed change in the base that is attributable to non-residents is larger (68 per cent) than their share (53 per cent) of the existing base. The net effect of all our proposals would have been to increase the total corporation tax base attributable to resident individuals by \$180 million. By contrast, the corporation tax base attributable to non-residents would have been increased by \$380 million.

In addition to increasing the corporation tax base, our proposals would require that a flat rate of tax be applied to all taxable corporate income. As is emphasized in Chapter 19, an integration scheme could not be fully implemented without adopting a flat rate of corporation tax. The effect of so doing would have been to raise the average rate of corporation tax to 50 per cent from about 41 per cent for resident individuals and from about 49 per cent for non-residents. The net effect of this change in effective tax rates together with the increase in the corporation tax base would have been to raise revenues from the corporation tax by \$538 million. After allowing for the recommended elimination of section 105 taxes, taxes collected at the corporate level would have been increased by \$532 million. Table 35-6 shows the allocation of these changes to residents and non-residents.

Because the corporation and personal income taxes would be fully integrated under our proposals, the amount of tax paid at the corporate level

TABLE 35-5

CORPORATE SOURCE INCOME ATTRIBUTABLE  
TO RESIDENT INDIVIDUALS IN 1964  
UNDER OUR PROPOSALS  
(millions of dollars)

Amount of the total 1964 corporation tax base attributable to resident individuals		
Portion of the present corporation tax base attributable to residents (Note 18)		2,062
Portion of the net increase in the base attributable to residents (Note 19)		<u>180</u>
		2,242
Less: allowance for the portion of the base attributable to trustees of Registered Retirement Income Plans, charitable organizations, and certain other similar organizations generally exempt from tax, which portion would not have been immediately taxable (Note 20)		<u>100</u>
Total 1964 corporation tax base attributable to resident individuals		2,142
Other income from corporate sources		
Realized "goodwill" gains on shares of corporations (Note 21)	451	
Dividends not carrying credit for corporation tax (Note 22)	<u>22</u>	<u>473</u>
Total corporate source income of resident individuals		<u><u>2,615</u></u>

Note: For an explanation of the Notes, see Appendix A to this Volume.



TABLE 35-6

CHANGES IN 1964 TAXES ACCRUED AT THE CORPORATE  
LEVEL AS A RESULT OF OUR PROPOSALS  
(millions of dollars)

Taxes accrued at the corporate level  
in 1964, including taxes on section 105  
distributions to residents (Note 23)

Attributable to residents, including  
trustees of Registered Retirement  
Income Plans, charitable organizations  
and certain other organizations  
(Notes 24 and 28)

860

Attributable to non-residents (Note 25)

1,081

1,941

Taxes accrued at the corporate level  
under our proposals

Attributable to residents (Note 26)

1,121

Attributable to non-residents (Note 27)

1,3522,473

Net increase in taxes accrued at the  
corporate level

532

Increase attributable to residents a/

261

Increase attributable to non-residents

271532

Notes: For an explanation of the Notes, see Appendix A to this Volume

a/ It should be noted that the increase in taxes accrued at the corporate level attributable to residents would have been more than offset by the reduction in personal income tax resulting from integration of the personal and corporation income taxes.

on shares owned by residents would not in itself affect the total taxes paid by or on behalf of residents. As is shown elsewhere the total tax levied on corporate source income of residents would actually be reduced under our proposals. However, our integration proposals could not be applied to non-residents taxed by other countries. The overall effect of our proposals on non-residents would result almost entirely from the change in corporation tax liabilities 4/.

#### Changes in the Personal Income Tax Base

Because of the complexity of the effects of our proposals on the yield of the personal income tax, we have divided this discussion into two parts. In this subsection, we show how our proposed reforms would change the personal income tax base; in the next subsection we explain the effects of our recommendations on the revenue yield from the proposed new base.

Numerous reforms altering the personal income tax base have been recommended throughout this Report. However, most of these reforms, while important in their effects on the equity and economic impact of the system, would have only minor and offsetting effects on the revenue yield. In this subsection we consider only those proposed reforms which would bear significantly on tax revenues.

The proposals affecting the base may be divided into two major groups:

1. Reforms affecting the scope of assessable income.
2. Reforms affecting deductions such as concessionary allowances and family exemptions.

Many of the proposals in the second group would substitute tax credits or rate schedules with zero rates in the lowest bracket for exemptions and for other deductions, and thus would be changes in the way in which the base was taxed rather than changes in the base itself. Each of these two groups of proposals will be discussed in turn.

The major reforms in the first group--those affecting the scope of assessable income—are contained in the following list:

1. Attribution of personal benefits now given in lieu of salary by employers or written off as deductible expenses by self-employed individuals. Included in this category are benefits received from group life insurance, from accident and sickness insurance (other than reimbursements of expenses), from strike funds and from unemployment insurance and workmen's compensation payments, and also the benefits discussed in Chapters 14 and 16, namely, benefits accruing under non-registered pension plans, stock options and deferred income plans, death benefits, severance allowances, recreational facilities, club dues, goods and services subsidized by an employer and the personal benefit derived from travel and entertainment expenses.
2. Taxation of property gains realized by individuals. Included in the effects of this proposal are the revenue consequences of allied recommendations such as the option to fully offset property losses against income, whether realized or accrued, and the taxation of property gains realized by non-residents on real property and rights to real property, along with the effects of our proposals for the taxation of gambling gains and other minor additions to the tax base.
3. Increase in the amount of investment income included in the tax base. The primary changes included in this category are the attribution to life insurance policyholders of investment income accumulated for them; the inclusion in income of all participating dividends paid by credit unions, co-operatives and mutual life insurance companies; and the effect of improved reporting requirements, including the requirement to record interest on a partial accrual basis, on the amount of interest payments and dividends included in income. Included also are certain minor changes such as the elimination of deductions of stockholder depletion allowances.



4. Inclusion of gifts and bequests. This category contains all gratuitous transfers from outside the family unit, other than government transfer payments. These include gifts, bequests and proceeds of insurance policies on the lives of persons who are not members of the family unit, in respect of some of which the donor is now taxable.
5. Inclusion of government transfer payments. In this category are family allowances, youth allowances and family assistance payments. While we have recommended the inclusion of other transfer payments in the tax base on equity grounds, their revenue significance is negligible and they have consequently been ignored in our analysis of revenue yield.
6. Extension of loss carry-forward provisions and acceleration of capital cost allowances for new and small businesses. This category is concerned with the effects of these proposals on unincorporated business profits, and with an estimate of the increase in the tax base resulting from other proposed reforms affecting the scope of income for unincorporated businesses.
7. Allowance of employment expenses. These recommended reforms provide both for liberalizing the deductibility of costs of earning employment income and for an optional deduction of 3 per cent of wages and salaries, up to a maximum of \$500, for taxpayers who do not itemize employment expenses. They also provide for the deduction of unemployment insurance premiums paid by employees.
8. Integration of personal and corporation income taxes. Under our proposals, the tax base of the individual would usually include his share of the before-tax net income of corporations in which he owned stock, rather than just corporate dividends received as at present. Although this would result in an increase in the personal income tax base, it would not in fact increase the aggregate tax base, as corporate profits are now subject to the corporation income tax.

9. Widening the integrated corporate base. As a result of integrating corporation and personal income taxes, increases in the corporation tax base discussed in the preceding subsection would result in increases in the personal income tax base to the extent that they were attributable to resident individuals.

The effect of each of these proposed reforms on the amount of income from various sources included in the tax base is shown in Table 35-7. As this table indicates, the net effect of all nine categories of reforms would have been to add \$4,894 million to the personal income tax base, the major additions being increases in the amounts included as income from corporate sources and from other (non-share) investments.

As noted in the discussion of each proposed reform, part of the amount thus added to the personal income tax base is currently subject to other taxes. In Table 35-8, the additions to the personal income tax base from each component are broken down between gains now exempt from tax or not reported and gains now subject to other taxes.

As this table indicates, 71 per cent of the \$2,169 million of corporate source income added to the personal income tax base is now taxed at the corporate level; likewise, \$1,200 million of other income received as gifts and bequests is in part currently subject to gift and estate taxes. Because the corporation tax paid on income brought into the personal income tax base of residents would be refundable to such taxpayers or applicable as a credit against their personal income tax under our integration proposals and because we have recommended abolition of gift and estate taxes, these additions to the tax base would not necessarily result in increases in tax revenues.

The proposed reforms listed up to this point would affect the tax base through changing the scope of assessable income. From assessable income it would be necessary to deduct concessionary allowances and family exemptions to arrive at taxable income, and we turn now to an analysis of the effects of our proposals concerning these allowances and exemptions.

TABLE 35-7

THE EFFECT OF PARTICULAR REFORMS ON EACH COMPONENT OF ASSESSABLE INCOME FOR 1964  
(millions of dollars)

	Employment, Professional, and Commission Income	Income from Corporate Shares	Unincorporated Business Income, Including Farming and Fishing	Other Investment Income	Other Income	Total
Categories of income added to the personal income tax base						
Attributable benefits (Note 29)	674	—	—	—	—	674
Realized property gains less property losses (Note 30)	—	451	95	249	—	795
Investment income (Note 31)	—	4	—	864	—	868
Gifts and bequests (Note 32)	—	—	—	—	1,200	1,200
Child support transfer payments (Note 33)	—	—	—	—	471	471
	674	455	95	1,113	1,671	4,008
Less: additional deductions allowed						
Extension of loss carry-forward provisions and acceleration of capital cost allowances for new and small businesses (Note 34)	—	—	56	—	—	56
Employment expenses (Note 35)	772	—	—	—	—	772
	772	—	56	—	—	828
	-98	455	39	1,113	1,671	3,180
Tax base added through integration of the corporation and personal income taxes (Note 36)	—	1,534	—	—	—	1,534
Tax base added through widening the integrated corporation tax base (Note 37)	—	180	—	—	—	180
Total assessable income added to the personal income tax base	-98	2,169	39	1,113	1,671	4,894

Note: For an explanation of the Notes, see Appendix A to this Volume.



TABLE 35-8

THE PRESENT TAX STATUS OF AMOUNTS ADDED  
TO ASSESSABLE INCOME FOR 1964  
UNDER OUR PROPOSALS  
(millions of dollars)

	Additions to the Base that are Now Subject in Whole or in Part to Other Taxes	Additions to the Base that are Exempt or Not Now Reported	Total Additions to the Personal Income Tax Base
Components of income			
Employment income, including the professional or commission in- come of self-employed taxpayers	—	-98	-98
Corporate source income <u>a/</u>	1,534	635	2,169
Unincorporated business income, including income from farming and fishing	—	39	39
Other investment income	—	1,113	1,113
Other income <u>b/</u>	<u>1,200</u>	<u>471</u>	<u>1,671</u>
Total additions to the personal income tax base	<u>2,734</u>	<u>2,160</u>	<u>4,894</u>

Notes: a/ Corporate source income currently taxed at the corporate level but included in the personal income tax base under our integration proposals includes \$1,534 million of before-tax corporate income attributable to resident individuals but not paid out in dividends, along with \$4 million in stockholder depletion allowances now deducted from dividends in computing the taxable income of individuals.

b/ Other income now subject to other taxes consists of gifts and bequests now taxed in part under the gift and estate taxes.

Source: Appendix A of J. Bossons, Changes in Direct Taxes on the Components of Income, a study published by the Commission.

We have recommended frequently that allowances and exemptions be replaced by tax credits or be incorporated in the rate schedule. Such allowances and exemptions generally purport to reflect a tax unit's ability to pay and are more equitable if formulated as credits rather than as deductions from income 5/. In most cases the specific credits we have recommended would result in larger average tax reductions than would the existing deductions under the schedule of tax rates which we have proposed. However, the replacement of deductions by credits and rate schedule adjustments necessarily would produce an increase in the amount of taxable income to which tax rates and credits were applied. To focus much attention on this change would be misleading; the importance of these proposals would lie in their effect on taxes paid at various levels of income.

The following are the major proposals pertaining to concessionary allowances and family exemptions that would be deductible in calculating taxable income:

1. Replacement of personal exemptions deductible by each taxpayer by zero rate brackets in the rate schedule. This change, essentially little more than a change in the name of this category of untaxed income, would apply to the \$1,000 and \$2,000 personal exemptions currently deductible by single and married taxpayers, respectively. The primary effect of this change would be to make the meaning of "taxable income" more in accord with most individuals' conception of "income" 6/.
2. Replacement of exemptions for dependants by tax credits. These proposals would substitute a number of different tax credits for the existing exemptions for dependants.
3. Replacement of educational deductions by tax credits. This group of proposals includes both the substitution of a tax credit for the deduction currently allowed for tuition fees and the provision of

tax credits to reflect the living costs of full-time students in post-secondary educational institutions.

4. Changes in the allowances made for medical expenses and the removal of the exemptions for the aged and infirm. Included in this category are the changes proposed in the definition of deductible medical expenses to reflect only actual cash outlays by the taxpayer, including medical insurance premiums, elimination of the old age exemption and the special exemptions for the blind and disabled, and removal of medical expenses from coverage by the optional standard deduction.
5. Changes in the deduction of charitable donations. Included in this category are the proposals to increase control over claims for charitable donations to ensure their validity, increase the range of donations eligible for deduction from income and reduce the standard deduction which would be claimable in lieu of itemizing charitable donations.

The effects of these proposed reforms on concessionary allowances and family exemptions deducted from total assessable income are set out in Table 35-9, which shows that the personal income tax base would be nominally increased by a total of \$12,261 million as a result of these proposals. However, all but \$505 million of this amount would consist of changes in the way in which allowances were granted and would not result in increased tax revenues.

Table 35-10 summarizes the effects on the personal income tax base of all the proposed reforms discussed in this subsection. Tables showing the current and proposed tax bases by income component for taxpayers grouped by income class and by age, occupation and sex are shown in a separate study 1/.



TABLE 35-9

THE EFFECT OF PARTICULAR PROPOSED REFORMS OF  
CONCESSIONARY ALLOWANCES AND FAMILY EXEMPTIONS  
DEDUCTED IN COMPUTING 1964 TAXABLE INCOME  
(millions of dollars)

	Increase in the Personal Income Tax Base Arising From	
	<u>Concessionary Allowances</u>	<u>Family Exemptions</u>
Replacement of certain deductions by zero rate brackets in the rate schedule or by tax credits		
Personal exemptions (Note 38)	—	9,311
Exemptions for dependants (Note 39)	—	2,335
Educational expenses (Note 40)	110	—
Changes in concessionary allowances		
Medical expenses and exemptions for the aged and infirm (Note 41)	149	—
Charitable donations and the standard deduction (Note 42)	<u>356</u>	<u>—</u>
Total increase in the personal income tax base	<u>615</u>	<u>11,646</u>

Note: For an explanation of the Notes, see Appendix A to this Volume. Because the zero rate bracket recommended for married couples and families would be larger than the existing \$2,000 personal exemption and because the recommended credits for dependants and educational expenses would be larger than what existing deductions are worth to the average taxpayer, all changes in exemptions and educational expense deductions would result in a net decrease in tax revenue. Only the changes in concessionary allowances would result in an increase in tax revenues.

TABLE 35-10

THE 1964 PERSONAL INCOME TAX BASE  
UNDER THE CURRENT AND PROPOSED TAX SYSTEMS  
(millions of dollars)

	<u>Current Tax Base</u>	<u>Changes in the Tax Base</u>	<u>Proposed Tax Base</u>
Components of income			
Employment income, including the professional or commission income of self-employed taxpayers	23,449	-98	23,351
Corporate source income	446	2,169	2,615
Unincorporated business income	1,186	39	1,225
Income from farming and fishing	601	—	601
Other investment income	917	1,113	2,030
Other income	<u>466</u>	<u>1,671</u>	<u>2,137</u>
Total assessable income	27,065	4,894	31,959
Deductions from income			
Family exemptions	11,646	-11,646	—
Concessionary allowances	<u>2,193</u>	<u>- 615</u>	<u>1,578</u>
	<u>13,839</u>	<u>-12,261</u>	<u>1,578</u>
Net personal income tax base	<u>13,226</u>	<u>17,155</u>	<u>30,381</u>

Sources: Tables 35-8 and 35-9 for changes to the tax base. The amounts shown under the current tax base were obtained by aggregating from adjusted data for each of the 417,000 tax returns in the 1966 Taxation Statistics sample as described in Notes 1 to 8 in Appendix A to this Volume.

## Changes in Personal Income Tax Revenue

Once the change in the personal income tax base that would result from our recommendations has been determined, it is a straightforward matter to compute what the gross income tax would have been before deduction of tax credits, provided that this is calculated for individual tax returns rather than by estimating aggregate revenues from data on the aggregate tax base. We were able to achieve this by using the computer programmes cited earlier to process the 417,000 tax return sample supplied to us by the Department of National Revenue 8/. The gross income tax payable for each tax return having been computed, it then remained to estimate the tax credits applicable in each case and to subtract these from the gross tax. Total revenues from the income tax were then estimated by aggregating the taxes computed for each return 9/.

The only portion of this process which was not a matter of straightforward calculation was the estimation of applicable tax credits. The non-refundable tax credits claimable by each taxpayer under our proposals are the following:

1. Credits for dependants. Included in this category are the credits for dependent children recommended in Chapter 11 and the credits for other dependants proposed in Chapter 12.
2. Credits for educational expenses. These include credits equal to one quarter of tuition fees plus \$300 to reflect living costs for non-dependent full-time students in post-secondary educational institutions, as recommended in Chapter 12.
3. Credits applicable to income components. The tax credits for working mothers proposed in Chapter 11 and foreign tax credits are grouped in this category. Changes in foreign tax credits proposed in Chapter 26 have not been included because we have assumed them to be offset by other changes; we have consequently assumed no change in these credits.



In addition to these non-refundable tax credits, our integration proposals call for a refundable tax credit against personal income tax of the corporation income tax attributed to resident shareholders. The total amount of these credits for all individuals filing tax returns in 1964 is shown in Table 35-11.

TABLE 35-11

TAX CREDITS APPLICABLE TO PERSONAL INCOME  
TAX FOR RESIDENT INDIVIDUALS IN 1964  
(millions of dollars)

## Non-refundable credits

Credits for dependants (Note 43)	515
Credits for educational expenses (Note 44)	109
Credits applicable to income components (Note 45)	63
	<hr/> 687

## Refundable credit

Corporation income tax attributable (Note 46)	<u>1,071</u>
Total tax credits	<u><u>1,758</u></u>

Note: For an explanation of the Notes, see Appendix A to this Volume.

Table 35-12 provides a comparison of the tax returns which would have been filed by the average 1964 taxpayer under the current (1966) tax system and under our proposals. The amounts for each of the various components of income shown on each of the two tax returns are averages of income assessable for all taxpayers and reflect all of the changes in the tax base previously discussed. Deductions, exemptions and tax credits are also shown as averages of total deductions and credits claimable under each tax system. For illustrative purposes, taxes under our proposals in this example have been calculated as an average of taxes derived from the family rate schedule and from the rate schedule for individuals.

TABLE 35-12

## CALCULATION OF TAXES FOR THE AVERAGE INDIVIDUAL TAXPAYER IN 1964

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 70	\$ 70	1. Wages and salaries	\$3,331	\$3,331
2. Retirement savings	57	57	2. Employment expense deductions	-5	-119
3. Net medical expenses	30	29	3. Professional income	102	102
4. Charitable donations	50	31	4. Commission income	61	61
5. Standard deductions	76	42	5. Attributable benefits	N.A.	100
6. Alimony paid	5	5	6. Farming and fishing income	90	90
7. Other deductions	<u>39</u>	<u>2</u>	7. Dividends	66	67
Total Deductions	326	235	8. Other corporate income	N.A.	255
Family Exemptions	<u>1,733</u>	<u>N.A.</u>	9. Capital gains on equities	N.A.	67
Total deductions and family exemptions	<u>\$2,059</u>	<u>\$ 235</u>	10. Unincorporated business income	177	183
			11. Net rental income	20	20
			12. Other Canadian investment income	115	244
			13. Non-business capital gains	N.A.	37
			14. Foreign investment income	6	6
			15. Deductions from investment income	-5	-5
			16. Gifts and bequests	N.A.	179
			17. Transfer payments	54	124
			18. Alimony received	3	3
			19. Miscellaneous income	<u>12</u>	<u>12</u>
			Total assessable income	4,028	4,757
			Total deductions and family exemptions	<u>2,059</u>	<u>235</u>
			Taxable income	<u>\$1,969</u>	<u>\$4,522</u>
<u>Tax Credits</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Tax Calculation</u>		
1. Credits for dependants	\$ N.A.	\$ 76	Personal income tax before tax credits	\$ 226	\$ 496
2. Dividend tax credits	12	N.A.	Total tax credits	<u>14</u>	<u>261</u>
3. Refundable credit for corporation tax	N.A.	159	Personal income tax	\$ 212	\$ 235
4. Other tax credits	<u>2</u>	<u>26</u>	Old age security tax	79	N.A.
Total tax credits	<u>14</u>	<u>261</u>	Corporation income tax attributable to the individual	121	159
			Taxes on gifts and bequests received	<u>21</u>	<u>N.A.</u>
			Total direct taxes	<u>\$ 433</u>	<u>\$ 394</u>

Note: All figures listed under the current system except for personal income tax, old age security tax and corporation income tax are averages of the total amounts assessed in each category for 6,719,445 resident taxpayers in 1964, adjusted to take account of the effect of changes in tax law enacted between 1964 and 1966. Amounts entered under the proposed system reflect estimates previously reported of the most important effects on the tax base of the major changes in tax law proposed by the Commission. Personal income and old age security taxes are calculated using the applicable rate schedules and are not equal to the average personal income taxes paid or which would be paid under either system. In computing taxes under the proposed system it has been assumed that the tax paid by the average taxpayer is an average of what would be paid under the rate schedule for individuals and what would be paid under the family rate schedule. The 1966 rate schedule has been used to compute personal income tax under the current system. All taxes are exclusive of provincial taxes but are before abatements to provinces. Some columns do not add to totals because of rounding.

As this table indicates, assessable income would have been increased under our proposals by \$729 for the average taxpayer. Assessable income less concessionary allowances but before deducting exemptions would have been increased by a larger amount, namely, by \$820 as a result of decreases in concessionary allowances and the substitution of tax credits for educational expense deductions. In spite of this increase in the tax base, total direct taxes would have been reduced.

The data in Table 35-12 provide only an example of the calculations for the average taxpayer. They cannot be taken as indicative of what the average change in taxes would have been, because average taxes paid depend on how income is distributed among taxpayers and not just on average income. Moreover, the example shown in Table 35-12 is artificial in that it is a composite of all 1964 tax returns rather than an example of a particular return. These comments apply equally to the examples of average taxes for seven groups of tax returns presented in Appendix B to this Volume.

Total tax revenues were estimated by calculating taxes payable for the average taxpayer in each of 19,370 groups 10/, multiplying average taxes by the number of taxpayers in each group, and then adding together the estimates 11/. The result is shown in Table 35-13. As this table indicates, the net effect of the recommendations discussed above would have been to increase personal income taxes from \$2,676 million to \$2,699 million.

After calculating the change which would have occurred in personal income taxes in this manner, it is necessary to allow for two additional categories of reform that were not included in any of the reform groups analyzed up to this point:

1. Aggregation of incomes of individuals in family tax units. As already noted in Chapter 11, the effect of defining the family to be the unit of taxation, given the rate schedule we recommend, would be to aggregate incomes received by all individuals in the family unit and to tax this



aggregated income at the tax rates applicable to the family unit.

This aggregation would increase the average income in a unit and because of the progressive rates would increase taxes for families with higher incomes.

2. Allowance of income averaging. A number of ways in which taxable income could be averaged are recommended in Chapter 13. The effect of these proposals would be to reduce tax revenues.

The effects of these additional categories of reform are estimated to be approximately compensatory. In Table 35-13, they are calculated to decrease revenue from the personal income tax by \$15 million. Taking into account all the proposed reforms, personal income tax revenue which would have been accrued in 1964 is estimated to be \$8 million higher under our proposals than under the current tax system.

In addition to this net change in personal income taxes, tax revenues from individuals and exempt institutions would have been changed by the full credit for corporation tax allowed under our proposals on taxed corporate source income attributable to the trustees of Registered Retirement Income Plans and to certain exempt institutions such as charitable organizations. Because the full allowance of tax credits to institutions would be partially offset by the attribution after a delay, of additional corporate source income in the form of retirement income to resident individuals, only the sum of the net additional deferment of tax on Registered Retirement Income Plans and the tax credits attributable to exempt institutions has been shown in Table 35-13. After allowing for the net effects of this credit, 1964 taxes levied at the personal level are estimated to be decreased by \$42 million by our proposals.

#### Changes in Sales Tax Yields

Table 35-14 shows an estimate of the retail sales tax base that would have been taxed in 1964 under the recommendations in Chapters 28 and 29.

TABLE 35-13

TOTAL TAX REVENUE COLLECTED AT THE PERSONAL LEVEL UNDER  
THE CURRENT AND PROPOSED TAX SYSTEMS FOR 1964  
(millions of dollars)

	<u>Under the Current System</u>	<u>Under the Proposed System</u>
Net tax base	<u>13,226</u>	<u>30,381</u>
Gross tax before credits	2,770	4,372
Non-refundable tax credits	95	687
Less: unused credits (Note 47)	<u>1</u>	<u>85</u>
	94	602
Tax credits refundable to individuals	<u>—</u>	<u>1,071</u>
Total tax credits	<u>94</u>	<u>1,673</u>
	2,676	2,699
Adjustments for excluded reforms		
Effect of aggregating income in family units (Note 48)	—	45
Less: effect of extension of income averaging (Note 49)	<u>—</u>	<u>60</u>
	<u>—</u>	<u>-15</u>
Total personal income tax revenue	2,676	2,684
Allowance for the net effect of extending the corporation tax credit to certain tax-exempt intermediaries (Note 20)	<u>—</u>	<u>-50</u>
Total tax revenue collected at the personal level	<u>2,676</u>	<u>2,634</u>

Note: For an explanation of the Notes, see Appendix A to this Volume. It should be noted that current "net tax" includes the old age security tax; both "net tax" figures are before abatement of tax to the provinces. The figures listed under the current system reflect the law as at December 31, 1966.

TABLE 35-14

ESTIMATE OF THE 1964 SALES TAX REVENUE UNDER  
THE PROPOSED FEDERAL RETAIL SALES TAX  
(millions of dollars)

Revenue yield of the current sales and excise taxes (from Table 35-3)		1,597
Proposed tax base		
Retail sales	12,800	
Building materials	4,170	
Other goods	<u>1,460</u>	
	18,430	
Less: federal sales and excise tax collections	<u>1,400</u>	
Total goods in the tax base	17,030	
Taxable services	<u>4,000</u>	
Total retail sales tax base	<u><u>21,030</u></u>	
Change in tax revenue		
Revenue from the proposed tax (7 per cent of the base)		<u>1,472</u>
Reduction in revenue		<u><u>125</u></u>

Source: Appendix D to this Volume.



The retail and service trade figures have been taken from 1961 census data provided by the Dominion Bureau of Statistics and have been corrected for the growth in personal expenditures between 1961 and 1964 as reported by the Dominion Bureau of Statistics in the National Accounts. The basis for this and other estimates of the sales tax base is presented in Appendix D to this Volume.

There was a marked increase in the yield from the manufacturer's sales tax in the years 1963 to 1965 because the exemption for production machinery and building materials was gradually eliminated. However, legislation has been enacted to eliminate the tax on production machinery, so that part of this increase will be reversed. The effect of these changes upon the revenue yield of the present sales tax has already been shown in Table 35-3. As that table indicates, the 1964 revenue from the current sales tax, as adjusted for these changes, and from certain excise taxes that we recommend should be eliminated, would have been \$1,597 million. Thus, to produce the same revenue in 1964 from the proposed retail sales tax base as would have been derived from the sales and excise taxes which we propose be eliminated would have required a tax on retail sales at a rate of 7.6 per cent. This rate is based upon the assumption that the services which would be subject to sales tax are those listed in Table D-3 in Appendix D to this Volume. Although we have not made a firm recommendation in this regard, we have suggested that these services are the ones that are primarily concerned with individuals and need not therefore be subject to extensive exemptions to allow for those services that enter into business costs. Telephone and telegraph charges have also been included because they are taken into account to a great extent in the present base for provincial retail sales taxes.

As we state in Chapter 7, we believe that sales taxes are inherently a less equitable form of taxation than income taxes and therefore we recommend that the relative weight of sales taxes be reduced. We recommend a tax rate of 7 per cent on retail sales.

The revenue yield of the proposed tax would then be equal to 7 per cent of the base shown in Table 35-14, or \$1,472 million. Our recommendations thus would result in a decrease of almost 8 per cent in sales and excise tax revenue.

ANALYSIS OF THE REVENUE EFFECT OF  
EACH MAJOR RECOMMENDATION

In the previous section of this chapter, the total effect of our recommendations on tax revenues was described. In this section we break down the total effect into the components accounted for by each group of recommendations.

Because of the different marginal tax rates faced by different taxpayers and because of the effect of our proposed reforms of the tax base upon the marginal tax rate applicable to each taxpayer under the proposed rate schedule, it is possible to allocate a change in tax revenues among the reforms only by adopting arbitrary means of allocation. Some reforms of course would have effects which were independent of the effects on other reforms. The provision of tax credits for working mothers, to take one example, would involve no change in the tax base and hence would be independent of the other reforms applicable.

The method of allocating the estimated change in taxes to the reforms causing the change is described in Appendix C to this Volume. The allocation was made for each taxpayer in the 1966 Taxation Statistics sample. The estimates shown in Table 35-15 were obtained by adding together the results of the proration for each taxpayer.

It must be emphasized that Table 35-15 shows the effect of the reduction in personal income tax rates as a separate reform. All other reforms affecting revenue from the personal income tax are evaluated at the tax rates which we have recommended.

Table 35-15 demonstrates that even though total personal income tax revenue would be little changed, the effect of our proposals would be to alter its composition substantially. Over a billion dollars in additional personal income tax revenue would be obtained from items brought into the tax base, while somewhat more revenue would be lost through general rate reductions, integration of the personal and corporation income taxes, the revisions applicable to Registered Retirement Income Plans and the allowance of certain other deductions and credits. As a consequence, significant changes could be expected in the incidence of taxes, as indeed we show to be the case in Chapter 36.

TABLE 35-15

THE PRORATED EFFECT OF PARTICULAR REFORMS ON 1964 TAX REVENUES  
(millions of dollars)

	Personal Income <u>Tax</u>	Corporation Income <u>Tax</u>	Gift and Estate <u>Taxes</u>	Sales <u>Tax</u>	<u>Total</u>
Changes in sales and excise taxes	—	—	—	-125	-125
Net reduction in personal income tax rates	-317	—	—	—	-317
Categories of income brought into the tax base					
Attributable benefits	132	—	—	—	132
Property gains by resident individuals and non-residents	243	—	—	—	243
Investment income added to the tax base	185	—	—	—	185
Gifts and bequests	353	—	-143	—	210
Transfer payments	68	—	—	—	68
Additional deductions allowed					
Extension of loss carry-forward provisions and acceleration of capital cost allowances for new and small unincorporated businesses	- 9	—	—	—	- 9
Employment expenses	-142	—	—	—	-142
Integration of corporation and personal income taxes	-363	252	—	—	-111
Additions to the integrated corporation tax base	- 28	280	—	—	252
Changes in concessionary allowances					
Replacement of dependant exemptions by tax credits	- 55	—	—	—	- 55
Changes in allowances for medical expenses and removal of the exemptions for the aged and infirm	25	—	—	—	25
Changes in the definition of charitable donations	45	—	—	—	45
Educational tax credits	- 72	—	—	—	- 72
Working mother credits	- 42	—	—	—	- 42
Other changes					
Income averaging	- 60	—	—	—	- 60
Aggregation of income in family tax units	45	—	—	—	45
Allowance for the net effect of extending the corporation tax credit to certain tax- exempt intermediaries	- 50	—	—	—	- 50
<b>Total</b>	<u>-42</u>	<u>532</u>	<u>-143</u>	<u>-125</u>	<u>222</u>

Sources: Table 35-6 and Appendix C to this Volume.



## TRANSITIONAL EFFECTS OF OUR RECOMMENDATIONS ON TAX REVENUES

In the tables discussed earlier in this chapter a major assumption underlying the estimates was that each recommendation had been in effect for a number of years. Therefore the resulting revenue calculations do not reflect the short-run impact of our recommendations and do not give effect to transitional provisions which we believed it necessary to recommend. We discuss each of these in turn and then summarize the overall implications of these transitional effects.

### Short-Term and Long-Term Impacts of our Recommendations

Most of the reforms that we have recommended would be fully effective when implemented. However, some reforms would have a different short-term impact from that described in the preceding section. We have recommended transitional provisions for some of our proposals so that they would be introduced gradually. These are discussed in the next subsection. In other cases the short-term impact may differ from the long-term impact for other reasons. Some reforms would take full effect only gradually because the income to which they applied would be taxable only when realized rather than when accrued, and realization may be deferred. Other reforms would have a larger impact initially than in the long term, in some cases because they would be immediately applicable to a larger number of taxpayers than would be true in later years.

The following are reforms that would have an initial effect that was smaller than their long-term effect:

1. Sales tax revenue. In Chapter 28 we point out that a change in the level at which sales tax is imposed, from the manufacturer's level to the retail level, would involve a non-recurring loss in tax revenues. As the retail inventories on hand at the effective date would have already been taxed at the manufacturer's level,

they should not be taxed again at the retail level. To prevent the levying of a second tax it would be necessary, in the year the change was introduced, to defer approximately \$175 million of sales tax revenue.

2. The taxation of property gains and losses. We recommend in Chapter 15 that the full amount of property gains be taxed and that, at least initially, such gains should be included in income only when realized. More important, from the standpoint of the effect on initial revenues, we have proposed a number of liberal transitional provisions and have stated that gains in property values accrued up to the effective date of the legislation should not be taxed. Thus, not only would revenue be deferred until property gains were realized, but only that part of gains which accrued in the future would be taxable.

Property losses, on the other hand, while they would in general be deductible only to the extent that they accrued subsequent to the effective date, could be written off on an accrual basis. Thus, while the tax revenue from property gains would be deferred, the revenue loss from the deduction of property losses would be immediate. While we estimate that in the long run the net amount of all property gains that would be included in income would be approximately \$1,000 million a year, with two thirds of this falling within our definition of corporate source income, we would expect this amount to be substantially smaller during the initial year after legislation was introduced, and that it would be several years before the revenues approached their full potential. As the total increase in tax revenues from the taxation of all property gains realized by residents and non-residents is projected at roughly \$330 million, the deficiency in tax revenues in the early years after implementation would be substantial. We have projected the total revenue shortfall from this source at \$700 million during the initial period following implementation of our proposals.

The following are the major proposals which would have either no long-term impact or a larger impact initially than in subsequent years:

1. Acceleration of capital cost allowances for new and small businesses. The extension of 100 per cent capital cost allowances on new depreciable property acquired by new and small businesses is discussed in Chapter 22. As pointed out earlier, over the long run the revenue impact would not be large, for only new businesses would be eligible to claim the accelerated allowances; the older businesses would have either used up the \$250,000 allowed or the ten-year time period would have elapsed and almost all of the capital cost would have been written off. Initially, however, the revenue cost would be substantial, as all companies meeting the size qualifications, regardless of how long they had been in business, would be eligible to claim the accelerated allowances. In 1964, capital expenditures, excluding the cost of land, incurred by companies earning a profit and having assets of under \$1 million exceeded \$650 million. As a large proportion of these companies would be eligible for the accelerated capital cost allowances, and as a major portion of their profits could thereby be eliminated until such time as the \$250,000 maximum write-off was reached or ten years had elapsed, the impact of this acceleration in the initial years might be substantial. We have estimated the total impact over the initial years to be \$400 million.

The timing of the impact of accelerated capital cost allowances could be controlled in a number of ways. The total impact could be spread over a period of years by limiting the amount that was deducted in any one year. A limit of this nature might also be useful in that it would even out the tax liabilities of small companies over a period of years. The loss of the low rate of corporation tax would thus be offset for a number of years by higher claims for capital cost allowances. In addition, the length of this period of higher



deductions could be extended by only gradually increasing the percentages deductible for all classes of depreciable assets.

2. Change in the allowance of reserves of certain financial institutions. One of our proposals would increase tax revenues in the transitional period, and would have only a minor effect thereafter. In Chapter 24 we recommend that the reserves of the chartered banks and the mortgage reserves of other financial institutions should be adjusted to conform to the general procedures applicable to other taxpayers. Reducing these allowances for doubtful accounts to the amounts we propose would increase the income of the institutions concerned, particularly the chartered banks. To reduce the impact of this adjustment, we have suggested that it be accomplished gradually over a number of years. Over this period our proposals would result in additional tax revenues of over \$100 million.
3. Acceleration of corporation income tax payments. One other recommendation would have a substantial impact in the transitional period as it would temporarily increase the tax revenues from corporate source income. In Chapter 33 we recommend that, to expedite the discharge of tax liabilities and to reduce the amount of unpaid balances, instalments of corporation income tax should be moved forward gradually to coincide with the year of taxation. Thus, the present four-month lag between the start of the taxation year and the beginning of instalment payments, which is a reduction from the six-month lag which existed prior to 1964, should be eliminated. This need not be accompanied by any change in the filing date for returns, although the formula for computing the amounts of instalments would be changed. While this acceleration of instalments would presumably be implemented over a period of two or more years, the total increase in tax revenues would be approximately \$550 million.

4. Allowance of corporation tax credits to trustees of Registered Retirement Income Plans. As discussed in Note 20 in Appendix A to this Volume, we have estimated the net deferment of tax on corporate source income attributable to the trustees of Registered Retirement Income Plans (together with the allowance of corporation tax credits to exempt institutions) to result in a net reduction of \$50 million in annual tax revenues. Because the proportion of the income of these plans which would be paid to beneficiaries would increase only gradually, a larger amount of tax would initially be deferred. We estimate the total revenue loss resulting from this additional deferment to be in the order of \$100 million.

In addition to the differential impacts of these specified reforms, initial revenue shortfalls from other proposals might occur, though in relatively small amounts. It is unlikely, however, that the total revenue loss from these unspecified transitional effects would be greater than \$50 million.

#### Revenue Effects of Transitional Provisions

It is recommended that most of our proposals should be implemented in full immediately because we consider that their impact would be equitable in the short term as well as over the long term and would not have undesirable economic effects. In these cases no specific transitional provisions would be necessary. However, in some cases it would not be fair to correct at one time what we consider to be weaknesses in the present system. For example, some of our proposals for corporate source income would have a significant impact on some taxpayers and if applied fully at one time might be harmful to the operations of the companies concerned. We therefore have proposed some specific transitional provisions to ease the impact.

To estimate the effects on annual revenue of the recommended transitional provisions is particularly difficult, for in a number of cases we have given

a range of choices as to how quickly the proposals should be brought into effect. This vagueness was based upon our feeling that decisions should have regard to economic considerations and revenue requirements at the time the legislation was introduced. As will be shown below, revenue considerations would be important when formulating many of the transitional provisions.

The following are the major transitional provisions and recommendations for which we have recommended a gradual or delayed introduction:

1. Delayed changes in the sales tax. We have recommended the expansion of the sales tax base to include listed services. As the full rate of tax would be applicable immediately, no specific transitional revenue cost would be involved. We have not included in our estimates any provision for the increase in revenues that would result as this list was expanded, nor have we taken into consideration our recommendation that eventually the sales tax on building materials should be eliminated.
2. Delayed repeal of the three-year exemption for the income of new mines. While it is recommended in Chapter 23 that percentage depletion allowances should be eliminated immediately, it is suggested that the three-year exemption of the income of new mines should continue to apply for five years, subject to a limit of \$1 million for any one mine. As substantially all of the present loss in tax revenues attributable to the three-year provision is accounted for by mines with incomes greatly exceeding this amount, this transitional measure would not materially reduce the expected increase in tax revenues. We assume the total revenue loss to be no more than \$25 million.
3. Write-off of exploration costs not previously deductible. The proposal to mitigate the withdrawal of percentage depletion by permitting the write-off of any exploration costs that were previously



not deductible because they exceeded depletion claimed in past years would have a substantial impact. The costs eligible for this treatment would primarily be certain land costs incurred by petroleum companies prior to the time when all their property costs became deductible. In Chapter 23 we point out that the excess of such costs over depletion claimed could well exceed \$300 million. Having regard to the large fraction of shares in petroleum companies that is owned by non-residents, we have estimated the transitional revenue loss from this source at \$150 million.

The impact of this recommendation would not all fall in the initial year, as we suggest that the deduction should be spread over a period of about five years. Nevertheless, the amounts concerned would be large. We have not projected any gain in tax revenues for the eventual lowering of capital cost allowances on development costs and the cost of land, since the effect of this would be felt only gradually.

In addition to these specific provisions, we have recommended numerous transitional provisions which would have only a very minor impact on revenues. The effect of these other provisions might total \$25 million.

#### Alternative Approaches to the Transitional Problem

Most of the measures affecting revenues during the transitional period outlined up to this point can be varied both in timing and in magnitude. In many cases we do not recommend which of several alternative transitional measures should be chosen. Since we would expect prevailing economic and revenue conditions to determine the time of introduction of our reforms and the form of the transitional provisions, there is little point in providing detailed estimates of the year-by-year impact of transitional effects.

We have made estimates of different possible combinations of the transitional effects on tax revenues of each major category of our proposed

reforms. These estimates are derived by simply spreading over a number of years the probable total effect of each reform. These estimates indicate that the net transitional effects of our recommendations need not total more than \$230 million in any single year, and should not total more than approximately \$1,000 million over the entire transitional period. The elements of this total are shown in Table 35-16.

Since the long-term effect of our recommendations, assuming a 7 per cent tax rate on retail sales and the income tax rate schedule advanced in Chapter 11, would be to produce a revenue surplus over the yield of the existing tax system of over \$200 million on the 1964 tax base and an increasing amount as the gross national product and per capita income increased, our estimates of transitional effects suggest that the tax rates we propose for initial adoption would provide sufficient revenue to pay for the costs of transition. Moreover, these estimates indicate that the full long-term revenue surplus set out in Table 35-1 would permit tax reductions approximately five years after the reforms we recommend were introduced.

In recommending rate schedules that would be more than adequate to absorb the transitional costs of introducing our recommendations and also to produce the same tax revenues as the present tax system over the long term, we have understated the reduction in rates which our reforms of the tax base would make possible. A number of alternative ways of financing transitional costs could be considered, all of which could be used to maintain tax revenues at a level equal to that yielded by the current tax system. Three such alternatives are:

1. A one-time tax on wealth, which we do not recommend.
2. A transition tax on corporate distributions, which is discussed in Appendix J to Volume 4.
3. A slowdown in the rate of increase in the acceleration of capital cost allowances for new and small businesses and in the write-off of exploration costs, combined with a modified form of either 1 or 2.

TABLE 35-16

REDUCTION IN TAX REVENUES DURING THE TRANSITIONAL PERIOD  
BELOW LONG-TERM TAX REVENUES UNDER OUR RECOMMENDATIONS  
(millions of dollars)

Effects of delays in the  
full impact of reforms

Sales tax (in first year)	-175	
Property gains (over several years)	<u>-700</u>	-875

Effects of reforms which would have either  
no long-term impact or a larger initial than  
long-term impact

Acceleration of capital cost allowances for new and small businesses (over several years)	-400	
Changes in the allowance of reserves of certain financial institutions (over varying time periods up to 10 years)	100	
Corporation tax payment acceleration (over several years)	550	
Allowance of corporation tax credits to trustees of Registered Retirement Income Plans (over several years)	<u>-100</u>	150

Cost of special transitional provisions:

Delayed repeal of the 3-year exemption for income from new mines (over 5 years)	- 25	
Write-off of exploration costs not previously deductible (over several years)	-150	
Other transitional provisions	<u>- 25</u>	-200

Other transitional effects - 50

Total transitional effects -975



We believe that our recommendation of a higher initial schedule of individual tax rates is more equitable than any of these alternatives. Each would result in a special transition tax on individuals and income components selected, with little regard to the extent to which the taxpayers who bore the tax benefited from our recommendations. If transitional costs were absorbed in the rate schedules they would be borne generally by all taxpayers in proportion to their ability to pay.

## CONCLUSIONS

### THE LONG-TERM EFFECT ON REVENUES OF OUR PROPOSALS

1. Because of the complexity of the interrelationship of the numerous reforms which we have proposed, we have relied primarily on an estimate of what the revenue yield of the recommended tax system would have been had it been in full effect in 1964, the most recent year for which we have detailed data. The change in revenue from each major tax affected by our proposals, that is, the difference between the revenue which would have been produced under our proposals and that which would have been produced under the tax system in effect in 1966, would have been as follows in 1964:

	<u>Millions of dollars</u>
Corporation income tax	532
Personal income tax	-42
Gift and estate taxes	-143
Sales and excise taxes	<u>-125</u>
Total change	<u>222</u>

This estimate excludes all transitional effects on revenues of our proposals, and it is therefore an estimate of 1964 revenues as they would have been if all of our recommendations had, at that time, been operative sufficiently long to have become fully effective.

2. The long-term changes in tax revenues would be the net result of the effects of a large number of proposed reforms. The effects of each major category of reform in the base year 1964 would have been as follows:

	Changes in 1964 Tax Revenues Resulting from each Reform (millions of dollars)
Net reduction in personal income tax rates	-317
Increases in income assessed under the personal tax base (excluding the effects of integration)	838
Integration of the corporation and personal income taxes	-111
Additions to the integrated corporation tax base	252
Additional deductions from the personal tax base	-151
Changes in concessionary allowances	-99
Allowance for the net effect of extending the corporation tax credit to certain tax-exempt intermediaries	-50
Allowance of income averaging	-60
Aggregation of income in family tax units	45
Changes in sales tax	-125
Total change	<u>222</u>

These estimates exclude all transitional effects. All changes, except for the reduction in tax rates, are evaluated in terms of the tax rates recommended in Chapter 11.

## TRANSITIONAL EFFECTS

3. Transitional effects on tax revenues arise from two major sources: (a) transitional provisions which we have believed it necessary to recommend, and (b) differences between the immediate impact of our recommendations and their long-term impact. The net result of all transitional effects would be to reduce tax revenues by approximately \$1,000 million over the entire transitional period, with most of this revenue loss falling in the first five years after implementation of our proposals.

## TAX RATES

4. The tax rates we have recommended are as follows:

Personal income tax:	the individual and family rate schedules and associated tax credits recommended in Chapter 11.
Corporation income tax:	50 per cent of taxable corporate income.
Sales tax:	7 per cent of retail sales and services included in the sales tax base.

These rates are designed to produce sufficient tax revenue to cover the revenue loss resulting from transitional effects during the first few years following introduction of our recommendations.



## REFERENCES

- 1/ "Assessable income" means the amount of income assessable for tax purposes after the deduction of expenses incurred in the earning of that income; "taxable income" means assessable income less concessionary allowances and family exemptions.
- 2/ The Department of National Revenue provided us with the extensive unpublished data that underlie our analyses, as well as with the preliminary versions of the tables to be published in 1966 Taxation Statistics summarizing 1964 personal and corporation income tax accruals and the underlying sample of tax returns. Without this data we would have been unable to make accurate estimates of the effects of our proposed reforms.
- 3/ The programmes and sample data are described in detail in J. Bossons, A General Income Tax Analyzer, a study published by the Commission. The sample supplied to us is the source of all aggregate data to be published by the Department of National Revenue in 1966 Taxation Statistics, Part One (Individual Tax Statistics for 1964). The tables to be published in 1966 Taxation Statistics are aggregated from the sample following the same procedure that was used in our revenue estimates.
- 4/ Some additional changes in the tax treatment of non-residents would include changes in withholding taxes and the remission of corporation tax to non-residents. However, the net effect of our proposals on withholding taxes would be minor.
- 5/ This point is discussed in Chapters 7 and 11.
- 6/ As is noted in Chapter 11, the difference between using exemptions and using zero rate brackets to achieve a relationship between taxes and income which accords with ability-to-pay principles is purely

semantic. To make this clear, the current rate schedules applicable to the income of single individuals and married couples without dependants, before the deduction of personal exemptions, are presented in Table 11-3 in Chapter 11. A married individual without dependants (other than his spouse) and with taxable income under current law of \$5,000 currently pays personal income tax of \$930, including old age security tax. This can be calculated either by using the rate schedule listed in section 32 of the Income Tax Act or by adding personal exemptions of \$2,000 to his taxable income and applying the rate schedule shown in Table 11-3.

- 7/ J. Bossons, Who Benefits and Who Pays: The Incidence on Different Income and Occupation Groups of Income Tax Changes Resulting from the Commission's Recommendations, a study published by the Commission.
- 8/ The computer programmes are described in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.
- 9/ Each tax return was chosen by the Department of National Revenue in accordance with different sampling rates, the sampling rates being dependent upon the taxpayer's assessable income and upon the type of return. In aggregating the taxes, data for each tax return was consequently first weighted by being multiplied by the reciprocal of the sampling rate governing selection of the return.
- 10/ The classification scheme is summarized in Appendix B to this Volume. Data from each tax return were weighted by the reciprocal of the sampling rate governing inclusion of the return in the sample in computing average income deductions and credits, and in estimating the number of 1964 taxpayers falling in each group. This procedure resulted in an estimate that a total of 6,719,445 tax returns were filed in 1966.
- 11/ The order and exact nature of each calculation is specified by the computer programmes listed in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.

## INCIDENCE OF THE PROPOSED SYSTEM

In Chapter 35 we discussed the total change in the tax revenues that would result from our proposed reforms. In this chapter we examine the effect of these proposed reforms on the weight of taxes upon individuals, and endeavour to show who would benefit from lower taxes and who would pay more taxes.

On the basis of figures for 1964, we have estimated that the proposed reforms after the transitional period would increase tax revenues by approximately \$222 million (Table 35-1). This would be the net result of an increase in taxes on non-residents of \$271 million (Table 35-6) and a decrease in taxes on residents of \$49 million. The increase in the taxes on non-residents would come about largely because of the preponderance of their investment in the resource industries and in certain financial institutions. Under the current tax system, these industries and institutions receive concessions which, under our proposals, would be withdrawn. Nowhere in the Report have we sought to shift the burden of tax from residents to non-residents or aliens simply because of their status. As previously stated, we believe that the tax system should remain as neutral as possible in the treatment of capital invested or services provided by residents and non-residents.

The reduction of \$49 million in the taxation of residents would result from a reduction in sales and excise taxes of \$125 million, offset by an increase of \$76 million in direct taxes. We have used the term "direct taxes" quite frequently in this volume to include corporation income taxes, gift and estate taxes and personal income taxes. It is necessary to consider these three taxes together, for our reforms would abolish gift and estate taxes and move their impact into personal income taxes, while the integration of personal and corporation taxes would make it impossible to



obtain meaningful comparisons of the total taxes from each of these sources under our proposals with what they are under the present system. However, it is quite possible and reasonable to compare the total weight of direct taxes on residents under the current and proposed systems. As we have stated, our proposals would increase this weight by approximately \$76 million.

In this chapter we show in more detail how different taxpayers would be affected by our recommendations. In doing so, we ignore transitional effects. On a long-term basis, the proposed tax system would raise more revenue than the present system, since we have recommended tax rates that would more than make up all transitional losses in revenue. Once transitional losses had been covered, within a few years after the implementation of our proposals, it should be possible to reduce further the taxes on residents.

To give a comprehensive picture of the total incidence of our proposals on taxpayers is an almost impossible task. The incidence of the present tax system varies considerably even among taxpayers who have similar incomes, occupations and family responsibilities, and our proposed reforms show the same variations. In this chapter we provide estimates of average changes in taxes for taxpayers grouped in various ways. Some of these estimates are for small groups of taxpayers and can serve as individual examples. For the most part, however, our estimates provide data only on the average impact of our proposals upon taxpayers in different income classes. Except where otherwise noted, "income" will be taken throughout this chapter to mean comprehensive base income, that is, total economic gains assessable under our proposals 1/.

While average changes do indicate the extent to which the progressiveness of the tax system would be altered by our recommendations, they are only indicative and must be interpreted with care. The misleading nature of averages used by themselves is partly shown by tables presented in this

chapter containing data on the number of taxpayers in each income class likely to experience varying percentage changes in taxes. Even these estimated distributions of taxpayers are in turn based on averages; the underlying estimates of changes in the tax base and in taxes for each taxpayer are dependent upon relationships between comprehensive income and currently assessable income and between concessionary allowances and family characteristics which are assumed to be valid on the average but cannot be valid for each individual taxpayer.

The incidence figures presented in this chapter need to be qualified in several other important respects. We have not attempted to adjust our estimates of tax incidence to reflect possible shifting of the taxes which are changed, and have consequently attributed all direct taxes to individuals to whom the income that is taxed is attributable 2/. In particular, corporation income taxes are attributed to shareholders and taxes on gifts and bequests are attributed to the recipients of the property. As in our analysis of the effects of our proposed reforms on tax revenues, so too, here, we assume that before-tax incomes would remain unchanged, even though we show in Chapter 37 that our proposals would tend to encourage an increase in the rate of growth of individuals' incomes. We confine our analysis to what the incidence of the changes in taxes would have been in 1964, since that is the last year for which we have detailed data for each taxpayer. Finally, we do not attempt to aggregate taxpayers into families, and so show the incidence of direct tax changes on each taxpayer and not on each family unit.

#### INCIDENCE OF CHANGES IN DIRECT TAXES

Under the tax rates we have recommended, direct taxes in 1964 would have been increased by \$347 million of which amount \$271 million would result from an increase in direct taxes on non-residents and the balance of \$76 million from an increase in direct taxes on residents. In this section we present estimates of the changes in direct taxes for individual taxpayers which would bring about this aggregate increase.

As noted in Chapter 35, fair estimates of the effects of our proposals on tax revenues could not have been obtained without the detailed analysis of average individual tax returns in each of a large number of taxpayer groupings and without the specification of the number of taxpayers in each grouping. This is even more the case with respect to our analysis of the incidence of tax changes among residents 3/. In this section we first provide more detail about the effect of tax changes on non-residents and then analyze the incidence of direct tax changes among residents 4/. For residents, we provide illustrations of tax changes for some taxpayers chosen as examples as well as data for all residents on incidence by income class and on incidence by income class for different occupation and age groupings.

#### Incidence for Non-Residents

While some changes have been recommended in withholding taxes and other changes have been proposed which would affect non-residents, the primary and, indeed, almost entire effect of our proposed reforms on non-residents would be the result of changes in the corporation income tax attributable to shares owned by non-residents.

Non-resident share ownership is heavily concentrated in large companies, and hence, of the changes to the corporation tax which we have recommended, non-residents would be affected primarily by our proposed changes in the corporation tax base. A large proportion of non-resident investments are in industries which have been taxed more lightly than other industries; as a result, non-residents would be materially affected by the elimination of concessions to these industries. The total corporation tax revenues from each of several industries which would be affected in different ways by our proposals are shown in Table 36-1 along with the corporation taxes attributable to non-resident owners of shares in each industry.



TABLE 36-1

CURRENT AND PROPOSED CORPORATION INCOME TAXES  
ATTRIBUTABLE TO RESIDENT AND NON-RESIDENT  
SHAREHOLDERS OF CANADIAN COMPANIES, BY INDUSTRY  
(millions of dollars)

	Estimated Corporation Tax Base for Taxable Companies Under Our Proposals	Current Corporation Income Taxes <u>Total</u>	Attributable to Non- Residents	Corporation Income Taxes Under Our Proposals <u>Total</u>	Attributable to Non- Residents
Mining, Oil and Gas					
Mining	501	117	79	251	185
Oil and gas	131	47	32	66	47
Financial Institutions					
Life insurance companies	154	2	1	77	33
General insurance companies and other financial institutions	240	93	25	120	43
Other industries	<u>3,920</u>	<u>1,676</u>	<u>944</u>	<u>1,959</u>	<u>1,044</u>
Total	<u>4,946</u>	<u>1,935</u>	<u>1,081</u>	<u>2,473</u>	<u>1,352</u>

Note: Corporation income taxes include old age security taxes and are before abatements to the provinces; taxes on section 105 distributions are not included in current corporation income taxes. The estimated corporation income tax base under our proposals includes additions to the base enumerated in Table 35-4. Taxes are attributed to non-residents in accordance with the assumptions stated in Notes 18, 19 and 24 in Appendix A to this Volume. It should be noted that these estimates yield more accurate estimates of the overall totals than they do of amounts in each industry.

## Incidence for Typical Residents

To illustrate the variety of ways in which our proposals would affect different taxpayers, we show in this section how direct taxes would be changed under our proposals for seven "example groups" of resident taxpayers. The different examples are described in Table 36-2, where direct taxes are set out for the average taxpayer in each group. This table does not reflect the proposed changes in the definition of the tax unit; all married taxpayers shown in Table 36-2 are limited to those married taxpayers whose spouses are not in receipt of employment income. The effect of the adoption of the family as the basic tax unit as described in Chapter 11 and is illustrated by the examples given in Appendix I to Volume 3. Tables 36-2 does not take into account the tax reductions resulting from income averaging.

The examples in Table 36-2 are described more fully in Appendix B to this Volume which also contains comparisons of pro-forma tax returns of average taxpayers in each group under the current and proposed tax systems. The calculations underlying the changes in taxes for each example can thus be followed by referring to this appendix. The basis for our estimates of the effects of our proposals in each case is summarized in Appendix A to this Volume.

To show the source of these changes in taxes, Table 36-3 indicates the amount of change attributable to particular groups of proposals for each example. Many of the reforms we recommend have offsetting effects. In general, the most important reform for most low income and middle income taxpayers would be the reduction in personal income tax rates, while the most important change for most high income taxpayers would be the bringing of income now untaxed into the tax base. Integration of the corporation and personal income taxes and elimination of taxes on intra-family gifts and bequests would result in further tax decreases for most taxpayers. The effect of the proposed changes in concessionary allowances would generally be minor.

TABLE 36-2

CHANGES IN DIRECT TAXES UNDER OUR PROPOSALS FOR THE AVERAGE TAXPAYER  
IN SEVEN GROUPS OF TAXPAYERS WITH PARTICULAR ATTRIBUTES  
(dollars)

	Change in Corporation Income Taxes Attributable to the <u>Taxpayer</u>	Change in Taxes on Gifts and <u>Bequests</u>	Change in Personal Income <u>Taxes</u>	Change in Taxes Paid on Retirement Income Plan <u>Investments</u>	Total <u>Changes</u>
1. Married male employees, 26 - 39 years old, with currently assessable income of \$5,500 - \$5,999 and one dependent child for whom family allowance is paid	2	-	-92	-11	-101
2. Married male employees, 26 - 39 years old, with currently assessable income of \$12,000 - \$12,999 and no dependants (other than spouse)	12	-207	123	-31	-103
3. Married self-employed pro- fessionals or business proprietors, male or female, 26 - 39 years old, with currently assessable income of \$30,000 - \$34,999 and more than 4 dependent children for whom family allowances are paid	74	-832	503	-107	-362
4. Married male investors or renters, 40 - 64 years old, with currently assessable income of \$30,000 - \$34,999 and more than 4 dependent children for whom family allowances are paid	7,784	-1,660	6,339	-29	12,434
5. Married male employees, aged 26 - 39, with currently assessable income of \$50,000 - \$74,999 and 2 dependent children for whom family allowances are paid	2,138	-2,254	3,933	-65	3,752
6. Single male, under 22 years old, unclassified by occupation, with currently assessable income of \$3,000 - \$3,499 and no dependants	3	-2	34	-3	32
7. Single male pensioner, over 64 years old, with currently assessable income of \$1,500 - \$1,749 and no dependants	11	-31	131	-	111

Sources: Appendix B to this Volume, Tables B-3 to B-9, for columns 1-3; Appendix C to this Volume, Table C-3, for column 4.



TABLE 36-3

BREAKDOWN OF TOTAL CHANGE IN DIRECT TAXES  
INTO COMPONENT PARTS FOR EACH EXAMPLE  
(dollars)

	<u>Change Caused By Reductions in Personal Income Tax Rates</u>	<u>Effect of Integrating the Personal and Corporation Income Taxes</u>	<u>Change Arising from Adoption of the Comprehensive Tax Base</u>	<u>Effect of Changes in Concessional Allowances</u>	<u>Other Changes</u>
1. Married male employees, 26 - 39 years old, with currently assessable income of \$5,500 - \$5,999 and one dependent child for whom family allowance is paid	-106	-3	24	-6	-11
2. Married male employees, 26 - 39 years old, with currently assessable income of \$12,000 - \$12,999 and no dependants (other than spouse)	-344	-15	420	-18	-146
3. Married self-employed profes- sionals or business pro- prietors, male or female, 26 - 39 years old, with currently assessable income of \$30,000 - \$34,999 and more than 4 dependent children for whom family allowances are paid	-2,426	-49	2,674	6	-568
4. Married male investors or renters, 40 - 64 years old, with currently assessable in- come of \$30,000 - \$34,999 and more than 4 dependent children for whom family allowances are paid	-2,425	-973	16,779	6	-953
5. Married male employees, aged 26 - 39, with currently assessable income of \$50,000 - \$74,999 and 2 dependent children for whom family allowances are paid	-5,791	-132	10,974	17	-1,316
6. Single male, under 22 years old, unclassified by occupation, with currently assessable income of \$3,000 - \$3,499 and no dependants	-5	-3	44	-	-4
7. Single male pensioner, over 64 years old, with currently assessable income of \$1,500 - \$1,749 and no dependants	-2	-21	90	60	-17

Notes: "Changes Arising from Adoption of the Comprehensive Tax Base" include the effects of widening the corporation income tax base and of eliminating the current taxes on gifts and bequests as well as increases in the personal income tax base arising from including capital gains, gifts, currently exempt investment income, and other currently exempt income.

"Other Changes" include the attribution of corporation income tax credits on the investment income of Registered Retirement Income Plans, and the attribution of taxes eliminated from intra-family gifts and bequests.

Some columns do not add to totals shown in Table 36-2 because of rounding.

Source: Appendix C to this Volume, Table C-3.

As Table 36-3 indicates, these generalizations do not apply in all cases. A significant exception is presented for low income pensioners with some investment income—the last of the seven examples. Fewer than 2,000 taxpayers fall into this group. The average taxes of these taxpayers would be significantly increased, primarily because of the effect of bringing more investment income into the tax base and of eliminating the \$500 special deduction for taxpayers over age seventy. In order to treat equally all taxpayers who had equal incomes and responsibilities it would be necessary to raise taxes for some individuals. If some of these effects were considered undesirable we believe they should be countered directly through transfer payments rather than by altering the tax system.

Despite the general similarities in the relative effects of each proposal there are substantial differences among these seven examples. A comparison of examples 1 and 2 using the data underlying Table 36-3, which data are presented in Appendix C to this Volume, indicates that the change in taxes would be virtually the same in both cases only because of an average tax reduction of \$114 resulting from the elimination of intra-family gifts received by the second taxpayer. In the sixth example, a significant portion of income received is investment income, a fact which results in an increase for the average taxpayer in this group even though many single males under 22 years old and with incomes of between \$3,000 and \$3,500 are likely to have income only from wages and salaries and so would experience a reduction in taxes. The third and fourth examples consist of taxpayers who differ only in age and occupation, but whose changes in tax liabilities would differ significantly.

As Appendix B to this Volume shows, only 15,591 taxpayers out of a total of 6,719,445 individuals filing tax returns in 1964 actually correspond to any of these seven examples. We consequently turn to a summary of the effects of our proposals on all resident taxpayers, classifying the 1964 tax returns by income in order to show the major incidence effects of our proposed reforms.

We subsequently summarize the differences in incidence patterns among different age/occupation/sex groups of taxpayers.

Incidence by Income Class  
for Residents

Table 36-4 shows average direct taxes paid by or attributable to resident taxpayers in each of 20 income classes. Under our proposals average direct taxes would be reduced for taxpayers with comprehensive base income below \$10,000 and increased for taxpayers with income in excess of \$10,000. The average change in direct taxes by broad income class is as follows:

<u>Income</u>	<u>Decrease in Taxes</u>	<u>Increase in Taxes</u>	<u>Percentage Change</u>
	\$	\$	
Less than \$5,000	19	-	-11.7
\$ 5,000 - \$ 9,999	22	-	-3.3
10,000 - 14,999	-	71	3.8
15,000 - 24,999	-	142	3.9
25,000 - 49,999	-	584	6.9
50,000 or over	-	8,472	26.0

As this tabulation indicates, direct taxes would be made more progressive under our proposals.

The extent to which the progressiveness of the tax system would be increased is shown more clearly by Table 36-5, which presents what the effective average rates of direct tax would be on the comprehensive base income of taxpayers in each income class. The average rate of tax as proposed gradually approaches 50 per cent as income rises. The current average rate, on the other hand, is both substantially lower than under the proposed system for incomes above \$50,000 and rises at a slower rate even between the last two income classes. This is so even though the proposed tax rate is by then already close to 50 per cent, which we have recommended as the maximum rate.



TABLE 36-4

AVERAGE INCIDENCE OF CHANGES IN DIRECT TAXES FOR CANADIAN RESIDENTS  
RESULTING FROM OUR PROPOSALS BY INCOME CLASS

Income Class	Number of Taxpayers in Class	Average Comprehensive Tax Base Income	Percentage of Comprehensive Tax Base Income Currently Assessable	Average Direct Taxes	
				Current	Proposed
		\$		\$	\$
Less than \$1,000	698,227	473	98.6	6	-
\$ 1,000 - 1,999	919,539	1,524	97.2	41	22
2,000 - 2,999	1,076,928	2,561	95.1	133	116
3,000 - 3,999	1,072,471	3,606	94.4	236	212
4,000 - 4,999	1,001,470	4,670	93.9	352	325
5,000 - 5,999	722,461	5,718	93.6	498	474
6,000 - 7,999	662,694	7,159	92.5	726	700
8,000 - 9,999	231,123	9,349	89.3	1,147	1,140
10,000 - 11,999	85,601	11,597	83.5	1,599	1,653
12,000 - 14,999	83,529	14,125	81.4	2,152	2,240
15,000 - 19,999	67,292	17,905	78.9	3,134	3,273
20,000 - 24,999	29,406	23,337	77.8	4,643	4,792
25,000 - 34,999	29,842	30,090	76.7	6,808	7,066
35,000 - 49,999	18,663	43,142	73.6	11,081	12,185
50,000 - 74,999	10,790	61,684	72.4	17,269	20,098
75,000 - 99,999	3,710	88,291	70.9	26,635	32,237
100,000 - 149,999	3,113	120,305	69.6	37,458	48,129
150,000 - 199,999	1,119	173,398	68.9	56,076	74,392
200,000 - 299,999	834	243,899	68.4	80,914	108,908
300,000 or over	633	565,523	68.7	199,685	267,234
All classes	6,719,445	4,756	89.4	540	554

Note: All taxes are before abatements to the provinces. Current taxes include old age security taxes, attributed corporation income taxes and attributed taxes on gifts and bequests. As in Appendix C to this Volume, proposed taxes include the attribution of deferred taxes on the investment income of Registered Retirement Income Plans. Calculations are as described in the listing of subroutine INCID2 presented in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.

TABLE 36-5

AVERAGE EFFECTIVE RATES OF FEDERAL DIRECT TAXES  
FOR RESIDENTS BY LEVEL OF INCOME DEFINED IN  
ACCORDANCE WITH OUR COMPREHENSIVE TAX BASE

<u>Income</u>	<u>Average Tax Rates on Comprehensive Tax Base Income</u>		<u>Change in Direct Taxes</u>
	<u>Current</u> %	<u>Proposed</u> %	%
Less than \$1,000	1.3	—	-101.9
\$ 1,000 - \$ 1,999	2.7	1.4	-45.0
2,000 - 2,999	5.2	4.5	-12.9
3,000 - 3,999	6.5	5.9	-10.2
4,000 - 4,999	7.5	7.0	-7.9
5,000 - 5,999	8.7	8.3	-4.8
6,000 - 7,999	10.1	9.8	-3.5
8,000 - 9,999	12.3	12.2	-0.7
10,000 - 11,999	13.8	14.3	3.4
12,000 - 14,999	15.2	15.9	4.1
15,000 - 19,999	17.5	18.3	4.5
20,000 - 24,999	19.9	20.5	3.2
25,000 - 34,999	22.6	23.5	3.8
35,000 - 49,999	25.7	28.2	10.0
50,000 - 74,999	28.0	32.6	16.4
75,000 - 99,999	30.2	36.5	21.0
100,000 - 149,999	31.1	40.0	28.5
150,000 - 199,999	32.3	42.9	32.7
200,000 - 299,999	33.2	44.7	34.6
300,000 or over	35.3	47.3	33.8
All residents	11.4	11.6	2.6

Note: Average effective rates of tax are calculated by dividing total direct taxes paid by or attributable to taxpayers in each class by the taxpayers' total comprehensive income. The reduction would be more than 100 per cent in the bottom income group because of the attribution of some credits for corporation income taxes to trustees of Registered Retirement Income Plans.

The projected changes in average direct taxes shown in Table 36-4 are partly the result of the proposed changes in tax rates, partly the result of proposed changes in assessable income, and partly the result of other proposals. The personal income tax rates which we recommend are substantially lower than current rates, and would result in lower taxes but for a proposed large increase in the tax base. The fraction of comprehensive base income assessable under current tax law for the average taxpayer in each income class is shown in Table 36-4. The fraction declines from almost 100 per cent for the lowest income groups to 69 per cent for the highest income groups. The large increase in assessable income under our proposals would more than offset the reduction in tax rates for the average upper income taxpayer.

The average change in direct taxes which would result from each of the major categories of the proposed reforms is shown in Table 36-6 for taxpayers in each income class. Except for the three lowest income classes, in respect of whom taxing the comprehensive base would result in a reduction in average taxes primarily because of the allowance of employment expenses, the effect of adopting the comprehensive tax base would be to increase average taxes substantially. This increase on average would be more than offset for taxpayers with taxable income under our proposals of less than \$10,000 by the combined effect of the rate reductions, of integrating the personal and corporation income taxes, of eliminating taxes on intra-family gifts and bequests and of allowing full credit for corporation income taxes attributable to the trustees of Registered Retirement Income Plans. However, because such a large proportion of the income of upper income taxpayers is at present untaxed, the effect of adopting the comprehensive tax base would be to bring about a substantial increase in the average taxes paid by taxpayers in such brackets. Needless to say, exceptions exist. Upper income employees or self-employed taxpayers obtaining income almost entirely as salary or as business or professional income would pay lower taxes.



TABLE 36-6

PARTICULARS OF AVERAGE CHANGES IN DIRECT TAXES  
FOR TAXPAYERS IN EACH INCOME CLASS  
(dollars)

<u>Proposed Taxable Income</u>	<u>Changes Caused by Reductions in Personal Income Tax Rates</u>	<u>Effect of Integrating the Personal and Corpo- ration Income Taxes</u>	<u>Changes Arising from Adoption of the Comprehensive Tax Base</u>	<u>Effect of Changes in Concessionary Allowances</u>	<u>Other Changes</u>	<u>Total Changes</u>
Less than \$1,000	-1	-4	-	-	-1	-6
\$ 1,000 - 1,999	-4	-4	-8	-1	-2	-19
2,000 - 2,999	-6	-8	-4	4	-3	-17
3,000 - 3,999	-24	-9	11	4	-6	-24
4,000 - 4,999	-46	-12	39	2	-10	-27
5,000 - 5,999	-56	-17	64	-1	-14	-24
6,000 - 7,999	-68	-29	103	-11	-21	-26
8,000 - 9,999	-79	-73	195	-14	-36	-7
10,000 - 11,999	-109	-149	390	-4	-74	54
12,000 - 14,999	-157	-200	563	-3	-115	88
15,000 - 19,999	-298	-324	905	8	-152	139
20,000 - 24,999	-549	-471	1,372	-2	-201	149
25,000 - 34,999	-982	-611	2,107	17	-273	258
35,000 - 49,999	-1,472	-901	3,900	27	-450	1,104
50,000 - 74,999	-2,105	-995	6,495	43	-609	2,829
75,000 - 99,999	-3,406	-687	10,657	54	-1,016	5,602
100,000 - 149,999	-3,992	-257	16,117	73	-1,270	10,671
150,000 - 199,999	-5,573	704	24,838	129	-1,777	18,321
200,000 - 299,999	-7,578	1,963	36,006	83	-2,485	27,989
300,000 and over	-19,088	7,079	84,359	117	-4,918	67,549
All classes	-56	-29	117	-	-18	14

Notes: "Changes Arising from Adoption of the Comprehensive Tax Base" include the effects of widening the corporation income tax base and of eliminating the current taxes on gifts and bequests as well as increases in the personal income tax base arising from including capital gains, gifts, currently exempt investment income, and other currently exempt income.

"Other Changes" include the attribution of corporation income tax credits on the investment income of Registered Retirement Income Plans, and the attribution of taxes eliminated from intra-family gifts and bequests.

Some columns do not add to totals shown in Table 36-4 because of rounding.

Source: Appendix C to this Volume, Table C-6.

The changes shown in Tables 36-4, 36-5 and 36-6 apply to the average taxpayer in each income class. Because of the wide variation in sources of income among taxpayers, there is similar variation in the ratio of currently taxed income to comprehensive tax base income. As a result, many different cases underlie the average. The extent to which taxes would be changed for taxpayers in each income class varies considerably from taxpayer to taxpayer.

Table 36-7 shows how the proposed changes in taxes would be distributed among taxpayers in each income class. The number of taxpayers in income classes whose taxes would be changed by more or less than 15 per cent as a result of our proposed reforms is as follows:

<u>Income</u>	<u>Numbers of Taxpayers for Whom</u>		
	<u>Taxes Would be Decreased by More Than 15 per cent</u>	<u>Taxes Would be Changed by Less Than 15 per cent</u>	<u>Taxes Would be Increased by More Than 15 per cent</u>
Less than \$5,000	2,713,328	1,685,259	370,048
\$ 5,000 - 9,999	404,144	1,038,796	173,338
10,000 - 14,999	5,269	125,901	37,960
15,000 - 24,999	1,895	70,918	23,885
25,000 or over	182	42,263	26,259
	<hr/>	<hr/>	<hr/>
Total .	3,124,818	2,963,137	631,490
	<hr/>	<hr/>	<hr/>

All in all, over 3.1 million taxpayers—46 per cent of all taxpayers—would have direct taxes paid by or attributable to them reduced by more than 15 per cent. Of these, almost 1.4 million would pay no direct taxes even though direct taxes are currently paid on income attributable to them. Somewhat over 630,000 taxpayers would have direct taxes attributable to them increased by more than 15 per cent.

The wide variation in the extent to which direct taxes would be changed for each taxpayer is primarily the result of variations in:

TABLE 36-7

NUMBERS OF TAXPAYERS IN EACH INCOME CLASS WITH DIFFERENT  
PERCENTAGE CHANGES IN DIRECT TAXES UNDER OUR PROPOSALS

Income	Number of Taxpayers for Whom Direct Taxes Would be Eliminated	Numbers of Taxpayers Who Would Still Pay Direct Taxes and for Whom Direct Taxes Would Be					Number of Tax- payers Added to Direct Tax Roll	Total
		Reduced by More Than 25 per cent	Reduced by 5 per cent to 25 per cent	Changed by Less Than 5 per cent	Increased by 5 per cent to 25 per cent	Increased by More Than 25 per cent		
Less than \$1,000	631,712	38,488	-	28,027	-	-	-	698,227
\$ 1,000 - \$ 1,999	352,543	245,013	151,853	89,560	30,603	48,813	1,149	919,559
2,000 - 2,999	196,444	237,678	156,478	315,434	32,355	87,592	947	1,076,928
3,000 - 3,999	150,858	171,832	311,967	289,598	64,673	73,913	1,630	1,072,471
4,000 - 4,999	41,411	234,008	294,772	300,114	73,171	57,004	990	1,001,470
5,000 - 5,999	5,138	51,841	347,924	207,074	60,905	48,229	1,350	722,461
6,000 - 7,999	902	18,432	379,962	122,385	90,819	49,282	912	662,694
8,000 - 9,999	295	2,231	123,332	38,707	46,453	19,596	9	231,123
10,000 - 11,999	39	585	37,332	14,370	21,256	11,969	-	85,601
12,000 - 14,999	97	149	28,355	18,593	27,244	9,090	-	83,529
15,000 - 19,999	23	63	25,777	11,838	23,318	6,268	-	67,292
20,000 - 24,999	9	51	11,106	4,711	11,493	2,036	-	29,406
25,000 - 34,999	4	23	11,556	5,168	9,563	3,528	-	29,842
35,000 - 49,999	1	3	628	7,828	6,678	3,525	-	13,663
50,000 - 74,999	-	1	46	2,526	4,258	3,959	-	10,790
75,000 - 99,999	-	-	-	224	1,817	1,669	-	3,710
100,000 - 149,999	-	-	-	93	1,087	1,933	-	3,113
150,000 - 199,999	-	-	-	22	278	819	-	1,119
200,000 - 299,999	-	-	-	19	131	684	-	834
300,000 or over	-	-	2	11	48	572	-	633
All classes	1,387,536	1,050,398	1,881,591	1,456,302	506,150	430,481	6,987	6,719,445

Note: As in Table 36-4, all direct taxes are before abatements to the provinces. Currently, direct taxes include old age security taxes, attributed corporation income taxes and attributed taxes on gifts and bequests. Proposed direct taxes would include taxes deferred on the investment income of Registered Retirement Income Plans. Calculations are described in the listing of subroutine ACCDEL presented in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.



1. The degree to which different taxpayers' incomes are currently exempt from tax.
2. The degree to which different taxpayers' incomes are currently subject to both personal and corporation income taxes.
3. Taxpayers' family status and eligibility for other allowances which can result in substantial tax changes by substituting tax credits for exemptions.

#### Incidence By Income Class for Different Age, Occupation and Sex Groups

The use of data on average changes in direct taxes attributable to taxpayers in each income class to measure the effects of our proposed reforms has the serious defect that taxpayers with different family responsibilities and different types of income are all grouped into one income class. Table 36-7 indicates the wide variation in tax changes for taxpayers in each income class; in this section we provide a further illustration of this variation by presenting data on changes which would occur in attributable direct taxes for taxpayers classified by age, occupation and sex as well as by income.

Table 36-8 shows the average changes which would occur in direct taxes attributable to taxpayers in selected income classes for some of the age/occupation/sex groups into which we have classified tax returns. The variation among these average changes is very great, especially for middle income taxpayers. For taxpayers with comprehensive tax base incomes between \$6,000 and \$7,999, the range of the average change in taxes in each age/occupation/sex group is \$333 (from a reduction of \$75 to an increase of \$258), roughly 45 per cent of all direct taxes currently attributable to the average taxpayer with this income. For taxpayers with incomes between \$12,000 and \$14,999, the range of the average change in direct taxes in each age/occupation/sex group is \$605 (from a reduction of \$137 to an increase of \$468), about one third of the average current direct tax on taxpayers with this income.

TABLE 36-8

AVERAGE CHANGES IN DIRECT TAXES ATTRIBUTABLE  
TO TAXPAYERS WITH SELECTED INCOMES IN  
SELECTED AGE/OCCUPATION/SEX GROUPS  
(dollars)

		Changes in Direct Taxes for Taxpayers With Incomes of					
<u>Age and occupation</u>	<u>Sex</u>	<u>1,000- 1,999</u>	<u>4,000- 4,999</u>	<u>6,000- 7,999</u>	<u>12,000- 14,999</u>	<u>25,000- 34,999</u>	<u>100,000- 149,000</u>
<u>21 years old or under</u>							
-	Male	-13	26	58	261	223	3,409
-	Female	-21	-17	54	277	1,074	12,770
<u>22 - 25 years old</u>							
-	Male	-24	-39	-44	73	1,475	12,079
-	Female	-24	-37	2	326	1,192	12,521
<u>26 - 39 years old</u>							
Employees	Male	-14	-49	-75	-85	-505	5,293
Employees	Female	-32	-53	-61	92	511	-
Farmers and fishermen	-	-2	-29	-55	-137	-318	-
Investors	Male	16	-152	50	344	435	11,762
Investors	Female	-26	-200	-64	447	770	12,728
<u>40 - 64 years old</u>							
Employees	Male	-7	-36	-54	-77	-339	6,605
Employees	Female	-29	-48	-2	244	602	10,507
Farmers and fishermen	-	-10	1	0	65	-261	9,018
Doctors, dentists and lawyers	-	-18	-72	60	79	-375	4,339
Other self-employed professionals	-	-28	-5	18	71	-176	4,434
Salesmen	-	-5	-18	3	-30	-411	4,839
Investors	Male	-39	22	210	371	1,304	12,640
Investors	Female	-9	47	157	307	1,440	13,101
<u>65 years old or over</u>							
Employees	-	17	32	41	-32	208	8,249
Farmers and fishermen	-	-6	76	179	376	692	10,617
Investors	Male	-38	134	258	468	1,386	14,748
Investors	Female	-64	69	192	409	1,707	13,686
Pensioners	Male	11	17	-21	-134	594	6,231
Pensioners	Female	29	95	70	265	-441	-

Note: Direct taxes attributable to taxpayers are those described in the note to Table 36-2. Taxpayers are classified into age/occupation/sex groups on the basis of major income source.

Source: J. Bossons, Who Benefits and Who Pays: The Incidence on Different Income and Occupation Groups of Income Tax Changes Resulting from the Commission's Recommendations, a study published by the Commission.

Needless to say, if there is this much variation in the class averages, there would be still more variation in changes for individual taxpayers. Table 36-9 shows the number of taxpayers in each age/occupation/sex group with incomes between \$6,000 and \$7,999 whose taxes would be changed by different percentages.

The reasons for the wide variation in tax changes has already been noted and can be illustrated by an examination of the seven examples previously discussed. Underlying data showing the relative importance of the effects of various proposed reforms as well as of tax base changes are provided in a separate study for taxpayers classified by income in each age/occupation/sex group 5/. The study also presents detailed data on the range of proposed tax changes in each income class for each age/occupation/sex group.

Some specific differences among groups are worth noting. For male employees under age 65, taxes would be reduced in all but the highest income groups, almost entirely as a result of the reductions in tax rates. Female employees would experience a larger number of tax increases, primarily because many female employees are married to husbands who have larger incomes and who claim all dependants and other allowable deductions. Moreover, because we have not aggregated taxpayers into family units, taxes under our proposals for married women filing as single have been calculated using the rate schedule for unattached individuals, thus overstating taxes for many married women in lower income groups 6/.

The varied changes in taxes for different groups noted in Table 36-8 can be further analyzed by using the detailed underlying data presented in the study just cited 5/.



TABLE 36-9

NUMBERS OF TAXPAYERS WITH INCOMES OF \$5,000 - \$7,999  
IN SELECTED AGE/OCCUPATION/SEX GROUPS WITH DIFFERENT  
PERCENTAGE CHANGES IN DIRECT TAXES

Age and occupation	Sex	Number of Taxpayers for Whom Direct Taxes Would be Eliminated	Numbers of Taxpayers Who Would Still Pay Direct Taxes and for Whom Direct Taxes Would Be					Numbers of Tax- payers Added to Direct Tax Roll	Total	
			Reduced by More Than 25 per cent	Reduced by 5 per cent to 25 per cent	Changed by Less Than 5 per cent	Increased by 5 per cent to 25 per cent	Increased by More Than 25 per cent			
<u>21 years old or under</u>										
-	Male	23	314	3,225	7,313	15,726	5,400	412	32,413	
-	Female	-	166	1,232	140	1,727	701	-	3,966	
<u>21 - 25 years old</u>										
-	Male	-	412	10,878	3,230	4,506	1	-	19,027	
-	Female	-	40	40	706	23	21	-	830	
<u>26 - 39 years old</u>										
Employees	Male	370	11,386	174,843	33,167	9,652	481	-	229,899	
Employees	Female	100	521	3,706	4,563	459	101	-	9,450	
Farmers and fishermen	-	2	360	1,176	645	445	-	-	2,628	
Investors	Male	-	127	62	20	20	260	20	509	
Investors	Female	-	50	766	65	40	100	5	1,026	
<u>40 - 64 years old</u>										
Employees	Male	320	3,128	172,637	38,409	27,665	2,090	25	244,274	
Employees	Female	20	590	4,212	15,594	2,363	-	-	22,779	
Farmers and fishermen	-	6	440	2,494	3,011	2,404	465	-	8,820	
Doctors, dentists and lawyers	-	-	42	42	202	277	81	1	645	
Other self-employed professionals	-	1	8	233	318	231	94	-	885	
Salesmen	-	-	80	1,415	1,527	1,081	305	20	4,828	
Investors	Male	1	40	595	120	777	3,599	65	5,197	
Investors	Female	-	130	25	1,576	720	1,922	-	4,373	
<u>65 years old or over</u>										
Employees	-	-	100	120	7,274	4,320	516	-	12,330	
Farmers and fishermen	-	-	-	-	140	1,761	546	-	2,447	
Investors and renters	Male	-	20	60	-	20	8,962	-	9,062	
Investors and renters	Female	-	20	-	-	5,915	295	-	6,230	
Pensioners	Male	-	-	1,795	2,155	301	170	-	4,421	
Pensioners	Female	-	-	-	1,175	1,190	101	-	2,466	
All classes		902	18,432	379,962	122,385	90,819	49,282	912	662,694	

Notes: As in Table 36-7, all direct taxes are before abate-ments to the provinces. Currently, direct taxes include old age security taxes, attributed corporation income taxes and attributed taxes on gifts and bequests. Proposed direct taxes would include taxes deferred on the investment income of Registered Retirement Income Plans. Calculations are described in the listing of subroutine ACDEL presented in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.

Source: J. Bossons, Who Benefits and Who Pays: The Incidence on Different Income and Occupation Groups of Income Tax Changes Resulting from the Commission's Recommendations, a study published by the Commission.

## INCIDENCE OF CHANGES IN SALES TAXES

Even though variation in spending patterns among households would result in some variation in the amounts of sales taxes paid on goods and services purchased by families with a given income, such variation would be small compared to the variation in direct taxes. The average changes in sales taxes attributable to families in broad income classes which would result from our recommendations are shown in Table 36-10. For families with incomes between \$2,000 and \$10,000, our recommendations would result in a decline of roughly 12 per cent in sales taxes paid. For families with incomes over \$10,000, sales taxes paid would be increased because of the enlargement of the sales tax base resulting from the inclusion of services.

## INCIDENCE OF ALL TAXES COMBINED

Because we have analyzed the incidence of direct taxes on the basis of the individual taxpayer rather than the family, it is difficult to combine our estimates of the incidence of direct taxes with the estimates of changes in sales taxes presented in Table 36-10. To do so, we have assumed average direct taxes attributable to families in each income class to be the same as the average direct taxes attributed to all taxpayers in the class, even though the combined effect of aggregating incomes in each family unit and taxing the aggregate income under the family rate schedule instead of the rate schedule for unattached individuals would be to reduce taxes somewhat for lower and middle income families and increase taxes for upper income families. Estimates of the combined effect of the proposed changes in direct taxes and sales taxes are shown in Table 36-11.

It is apparent from Table 36-11 that the net effect of our recommendations is to increase the progressiveness of the tax system. Total federally collected taxes on residents would be reduced on the average by roughly 10 per cent for families with incomes of less than \$5,000 and by roughly 7 per cent for families with incomes between \$5,000 and \$10,000.

TABLE 36-10

CHANGES UNDER OUR PROPOSALS IN AVERAGE SALES TAXES  
BORNE BY FAMILIES IN DIFFERENT INCOME CLASSES

<u>Income Class</u>	<u>Average Sales Taxes Paid or Attributed</u>		<u>Average Change in Tax</u>	<u>Percentage Change</u>
	<u>Current</u>	<u>Proposed</u>		
	\$	\$	\$	
Less than \$2,000	80	78	-2	-2.5
\$2,000 - 2,999	144	131	-13	-8.8
3,000 - 3,999	212	187	-25	-12.2
4,000 - 4,999	252	218	-34	-13.4
5,000 - 6,999	347	303	-44	-12.9
7,000 - 9,999	503	435	-68	-13.5
10,000 and over	722	856	134	18.4
All classes	269	248	-21	-7.8

Note: These estimates are based on 1961 data.

Source: Appendix E to this Volume.

TABLE 36-11

ESTIMATED CHANGES IN SALES AND DIRECT TAXES COMBINED  
FOR FAMILIES IN DIFFERENT INCOME CLASSES

<u>Income Class</u>	<u>Average Current Tax</u>			<u>Average Change in Taxes</u>	<u>Percentage Change</u>
	<u>Direct Taxes</u>	<u>Sales Taxes</u>	<u>Total</u>		
	\$	\$	\$	\$	
Less than \$2,000	26	80	106	-15	-14.6
\$2,000 - 3,999	184	180	364	-40	-11.0
4,000 - 4,999	352	252	604	-61	-10.1
5,000 - 6,999	575	347	922	-69	-7.5
7,000 - 9,999	909	503	1,412	-81	-5.7
10,000 and over	5,178	722	5,900	807	13.7
All classes	540	269	809	-7	-0.9

Note: Average direct taxes attributable to families in each income class are assumed to be the same as the average direct taxes attributable to all taxpayers in that income class. Current taxes include old age security taxes. All taxes are before abatements to the provinces. For other notes see Appendix E to this Volume.

Sources: Table 36-4 and Appendix E to this Volume.



Taxes would be increased on the average by 14 per cent for families with incomes in excess of \$10,000, though this average brings together a wide variety of changes in taxes for individual families with incomes over \$10,000.

#### CONCLUSIONS

1. Federal taxes would be changed as a result of our proposals, on the basis of 1964 income and disregarding transitional costs as follows:

	<u>Millions of Dollars</u>	
For non-residents - increase		271
For residents - reduction in sales and excise taxes	-125	
- increase in direct taxes	<u>76</u>	<u>-49</u>
		<u>222</u>

2. The increase in taxes on non-residents would result from the following changes in corporation taxes:
  - a) Elimination of concessions to the resource industries and some financial institutions.
  - b) Removal of the low rate of tax for small businesses.
3. The proposed reforms of direct taxes would have offsetting effects. The most important reform for low income and middle income taxpayers would be the reduction in personal income tax rates, while the most important change for most high income taxpayers would be the bringing of income now untaxed into the tax base.
4. Over 46 per cent of all taxpayers would have direct taxes paid by or attributable to them reduced by more than 15 per cent. About 10 per cent of all taxpayers would suffer increases in direct taxes of more than 15 per cent.

5. Federally collected taxes would be reduced by roughly 10 per cent on average for families with incomes of less than \$5,000 and 7 per cent for those with incomes between \$5,000 and \$10,000. For families with incomes exceeding \$10,000 the average increase would be 14 per cent.

## REFERENCES

- 1/ A minor exception to this statement is that taxpayers are classified by comprehensive base income less concessionary allowances, that is, by amounts of "taxable income" under our proposals. The effect of this is to make the taxpayers grouped in any income class more similar in their tax liabilities under our proposals, since taxes are computed on taxable income rather than on assessable income before the deduction of concessionary allowances. The difference between taxable income and assessable income is, in any case, little more than 5 per cent of assessable income for the average taxpayers in even the lowest income classes.
  
- 2/ The effects of possible shifting of taxes are discussed in general in Chapter 6; the effects of possible shifting of the corporation income tax are discussed in Chapter 19. An extensive investigation of the sensitivity of the overall incidence of the tax system to shifting of sales and corporation income taxes is presented in W. I. Gillespie, The Incidence of Taxes and Public Expenditures in the Canadian Economy, a study published by the Commission. Gillespie's study indicates that the overall incidence of the tax system is affected very little by changes in the amount of shifting assumed.
  
- 3/ As was true for the analysis of total revenue changes presented in Chapter 35, the analysis reported in this chapter is dependent upon the assumptions summarized in Appendix A to this Volume and upon the computer programmes and data described in detail in J. Bossons, A General Income Tax Analyzer, a study published by the Commission. The procedure followed in this analysis is described in Chapter 35 and in Appendix B to this Volume. The basic data consist of the information reported on each of 417,000 returns included in the sample underlying the tabulations in the Department of National Revenue 1966 Taxation Statistics, Ottawa: Queen's Printer.



- 4/ The term "residents" includes non-residents who receive income earned in Canada from wages and salaries, net rentals or other sources and who file Canadian personal income tax returns.
- 5/ J. Bossons, Who Benefits and Who Pays: The Incidence on Different Income and Occupation Groups of Income Tax Changes Resulting from the Commission's Recommendations, a study published by the Commission.
- 6/ A discussion of the changes resulting from aggregating taxpayers into family units is contained in Chapter 11.

THE ECONOMIC EFFECTS OF THE  
PROPOSED TAX REFORMS

A discussion of the probable economic effects of the income tax reforms we have proposed has been postponed until this point because we consider our proposals as parts of a unified structure rather than independent elements that can be considered in isolation from one another. It is their joint effect that is important. If any one of the major elements of the reform package were not adopted we believe that it would be necessary to modify one or more of the other elements. The individual proposals are designed to complement and, in some cases, compensate for one another.

Through our reforms we have sought to design a tax system that would be fair; but at the same time we wanted to develop a system that would not reduce the rate of economic growth. Equity, after all, has to be defined in terms of income received in future years as well as income received currently. There is little to be gained if, in the name of equity, the reformed tax system were to erode the sources of future income in order to redistribute current income. Our purpose here is to show that in achieving greater equity we do not have to sacrifice economic growth. Indeed, the tax system we propose should, by improving the allocation of saving, increase the growth rate without reducing current consumption or increasing our dependence on foreign capital.

We want to repeat what we stated in Volume 2. We have not tried to design a tax structure that would increase the growth rate by, in effect, forcing Canadians to work harder and consume less. Canadians may well be satisfied with the higher growth rate that could be achieved virtually without cost, that is, without reducing consumption, through the maintenance of full employment by a more effective use of fiscal policy and through the improved allocation of resources that could be brought about by the introduction of the tax reforms we recommend.

If it is generally agreed that increases in the growth rate beyond those that would result from the implementation of our recommendations should be pursued, despite the costs involved, the government should either change the mix of fiscal, monetary and exchange rate policies or adopt a system of investment tax credits, more accelerated capital cost allowances and more generous registered retirement income provisions. How the mix of policies could be altered to increase the growth rate is discussed in Volume 2, as are the specific tax measures that could be introduced for that purpose. We are convinced that it would be a serious mistake to distort the whole tax structure in an attempt to increase the rate of saving and investment when these more effective and more equitable methods are available.

To propose the adoption of an inequitable tax system that would force Canadians to bear the costs of a higher growth rate than they may want would be both presumptuous and foolish. Changing the aggregate saving and investment rate requires decisions that only our elected representatives should make. If, after public debate, it is decided that we should sacrifice more current leisure and more current consumption for more future goods and services, this goal should be pursued in the most efficient and equitable manner. By the use of policies that **affect** aggregate spending and saving Canadians can have an equitable tax structure and a higher rate of growth.

Earlier in the Report we explained in detail why we believe that the system we propose would be much more equitable than the present system. We explained fully how it could be applied and administered. But we have only briefly discussed how the recommended tax structure would change the allocation of resources and we have said virtually nothing about the effects it would have on aggregate saving and investment. The purpose



of this chapter is to fill in these gaps. In particular, we hope to be able to show that the adoption of the more equitable tax structure we recommend:

1. Would not reduce aggregate saving.
2. Would bring about a major reallocation of the flow of saving.
3. Would result in higher rates of fixed capital formation in those industries and corporations with the highest expected before-tax rates of return.
4. Would compensate more effectively than the present tax system for market biases that deter investment in new and risky ventures.
5. Would encourage more Canadian ownership of Canadian industry without creating unmanageable balance-of-payments problems.

The main point we seek to make is this: the present tax system grants concessions that are either inefficient in terms of revenue foregone relative to the results achieved, such as the low rate of tax on the first \$35,000 of corporate income, or are far too generous relative to the possible market biases for which they are supposed to compensate, such as mineral depletion. The replacement of inefficient concessions by efficient concessions would make it possible to provide more assistance where it is really needed. The withdrawal of unnecessary concessions would make it possible to reduce taxes where expected before-tax rates of return are higher. This would result in a shift in capital to more productive uses and hence in greater future output.

The chapter consists of eleven sections. The first section discusses the effects which the adoption of the proposed tax system would have on the quantity and quality of labour effort. Although this discussion is

to some extent a diversion from the main theme of the chapter we think it is desirable to pull together what has been said elsewhere in the Report on this important subject and to state the implications more explicitly.

The second section is concerned with the circumstances under which the tax system should be used to compensate for biases that distort the allocation of fixed capital. A brief summary of our recommendations that would have an important impact on the allocation of fixed capital is provided, together with an indication of the quantitative importance of an improved allocation of fixed capital.

We are proposing a multitude of changes that would interact in a complex way. Some of the changes would offset one another; other changes would together have a compound effect. In assessing the economic impact of the proposed system it is imperative, therefore, that these interactions be recognized and that the correct weights be given to the various recommendations. To assist in this weighting process we have made detailed estimates of the corporation income tax changes we propose, classified by industry, by type of reform and by ownership. These estimates, together with other pertinent data against which they can be compared, are provided in the third section.

In the following three sections we analyze the impact that our proposals would have on the rates of saving and fixed capital formation by businesses. Most attention is given to large, resident-owned Canadian corporations that do not have special industry tax concessions. It is shown that despite small tax increases at the corporate level, and the full taxation of share gains, the proposed integration of personal and corporation income taxes for resident shareholders would probably increase the rate of fixed capital formation for these corporations.

This expansion would be financed through a reduction in the proportion of earnings distributed and by an increased volume of new share issues.

On the basis of this framework we then consider the implications for non-resident-owned corporations, for corporations that now enjoy special industry concessions, for small corporations, for unincorporated businesses and for real estate. In the last of these three sections the overall effect on business saving is discussed and some estimates are provided. While the estimates are subject to a wide margin of error they show that on the basis of all of the information available, it is unlikely that business saving would decline.

The seventh section analyzes the effect that the adoption of the proposed tax system would have on the volume and form of personal saving. The available data indicate that the adoption of our proposals would lead to a modest reduction in personal saving. More important, a major change in the form of personal saving would occur with more funds flowing into riskier equity investments and less into safer, fixed income securities.

The estimates of the probable changes in business and personal saving derived earlier are brought together in the eighth section. They are considered in the context of the estimated change in government saving. It is shown that the small increase in government saving resulting from increased government revenues would offset the small reduction in private saving so that total domestic saving probably would not be changed by our proposals.

Adoption of the proposed system would induce some substantial changes in gross international capital movements. The ninth and tenth sections analyze the impact that these could have on the balance of



payments and discuss what might be done to increase the rate of growth if the increased growth resulting from the adoption of our recommendations was judged to be inadequate.

A final section of the chapter summarizes the discussion and recapitulates the conclusions.

From this brief summary of the contents of the chapter it is apparent that many of the economic effects of our proposals are not considered here. In particular, issues that have been discussed at length elsewhere in the Report, such as the international economic implications of our recommendations, distributional effects and the problems of maintaining economic stability, are not reopened except where they bear upon our main theme. The stability implications of our recommendations are not discussed because we are satisfied that the adoption of the proposed system would not alter materially the built-in stability of the system or make it more difficult to institute effective discretionary stabilization policies. Our main concern is with the impact of our proposals upon the future rate of growth; it is on this subject that this chapter is primarily focused.

#### EFFECTS ON THE QUANTITY AND QUALITY OF LABOUR EFFORT

The potential output of goods and services would be increased if Canada had a greater supply and a higher quality of labour effort. This could be achieved with a larger labour force, a better trained and educated labour force, and a labour force that was willing to work longer and harder. What evidence there is suggests that taxes have relatively little impact on the size, skill and industriousness of the labour force. Changes in its size and quality are for the most part probably explained by:

1. Changes in social and cultural factors that largely account for changes in the birthrate.
2. Changes in international disparities in living standards, employment opportunities and government policies that largely account for changes in net immigration.
3. Changes in industrial composition, retirement income and educational standards that largely account for changes in age-sex specific labour force participation rates.
4. The desire to substitute more leisure for more consumer goods and services as real income rises.
5. Irreversible declines in labour hours during periods of unemployment that, together with 4, largely account for changes in average hours worked by employed persons.

Our task would have been simplified had we been convinced that the supply of effort was solely determined by these factors. If this could have been assumed, it would have meant that changes in the tax structure would have no appreciable impact on the quantity and quality of available effort. We would then have been able to try to devise a fair and administratively feasible tax structure and to ignore the impact of the tax structure on the supply of effort. We were unable to accept this simplifying assumption and consequently have been forced to weigh the advantages and disadvantages of tax structure changes that would make the system more equitable and workable against changes that would tend to increase the supply of effort. Some of the more important factors that we have considered are discussed below.

#### Lower Marginal Rates

Provided that the family's average tax rate at its existing income level remains unchanged, the family is provided with an incentive to increase its labour income if the effective marginal tax rate applicable to labour

income is reduced. Many families would not be able to respond to this incentive, of course. Institutional restrictions upon hours of work and family responsibilities may effectively limit the number of hours of labour that the family can sell. However, there are other families who have the opportunity to sell more hours of employment. For these families the number of hours sold reflects the family's relative evaluation of the benefits of additional income and the benefits of additional leisure. In some circumstances, the head of the household may be able to work more hours at his major occupation, as in the case of the self-employed. Perhaps more frequently the head of the household can accept a second, part-time job or other members of the family can decide to enter the labour force, seeking either part-time or full-time work.

If marginal tax rates were reduced without a reduction in average tax rates it is impossible to predict how great a response there would be or how quickly the ultimate response would be felt, but the direction of the response would be clear: aggregate hours worked would increase.

It might be thought that a reduction in average rates of tax in addition to reduced marginal rates would increase the incentive to work. This is not likely to be the case. A reduction in average tax rates increases the disposable income that can be obtained with the same effort or, to put it another way, it reduces the effort needed to obtain a given disposable income. When average and marginal rates are both reduced some will choose both more leisure and an improved standard of living even though the rewards for additional effort are increased  $\frac{1}{2}$ . The net effect upon the supply of labour effort of a tax change that reduces both average and marginal rates of tax is therefore uncertain: lower marginal rates would always encourage greater effort; lower average rates would probably reduce effort.

We have proposed that the top marginal rate of the personal income tax be reduced from 80 per cent to 50 per cent and that this maximum rate be applied to income in excess of \$100,000. Under the present rate schedule a marginal rate of 50 per cent or more is applied to income in



excess of \$25,000. Other marginal rates in the middle and at the top of the schedule have been reduced correspondingly in the schedules we recommend. Consequently most taxpayers who depend primarily on wage and salary income and who do not obtain a large proportion of their remuneration in the form of benefits that have been tax free in the past would find their average tax rates reduced slightly and the marginal tax rates applied to additional income reduced materially 2/.

Because the adoption of our proposals would reduce both average and marginal tax rates on wages and salary income, it is impossible to determine a priori, what would be the net effect on the supply of labour effort. We are of the opinion, and it can only be an opinion, that where tax considerations are important, the negative effect on the supply of effort of the reduced average tax rates would be more than offset by the positive effect of lower marginal tax rates. However, because tax considerations are only of minor importance, we expect that the labour effort supplied by the vast majority would not be affected one way or the other.

The present system has high marginal rates but has many loopholes by which some upper income salaried people can obtain substantial tax-free or low tax benefits. Retirement allowances, pension deductions and, until recently, stock options were the most common methods of avoiding high marginal rates. It has been argued that these loopholes had to exist if Canadian businesses were to retain the best men and be able to bonus those who worked the hardest. With the reductions in average and marginal rates that we propose this argument would lose any validity it may have had. We have no hesitation in recommending that all benefits be brought into income and taxed at full rates.

#### Tax Inducements to Emigrate to the United States from Canada

Except at the bottom end of the income scale current Canadian income taxes are higher than current United States income taxes. This is particularly true for home-owning families with children. It is sometimes argued

that these tax disparities induce middle and upper income individuals and families to emigrate to the United States. We are sceptical that tax factors have been a major factor in emigration. There are many other, and, we believe, more significant pressures. Incomes in the United States are generally higher, living costs may be lower and, for some occupations and professions, more interesting work may be available there than here. In periods of unemployment in Canada emigration to the United States in search of work is also important. Moreover, it is misleading to compare taxes in the two countries and ignore differences in the benefits the two governments provide. But having said all this it cannot be denied that higher Canadian taxes may add to the reasons some people have for leaving Canada.

The rate schedules we recommend would not eliminate all tax inducements to emigrate to the United States. However, for those who depend primarily on employment and professional income the unfavourable differential would be substantially reduced for most family tax units. The tax comparisons shown in Table 37-1 support this statement.

With the exception of middle income unattached individuals who would be faced with small but unfavourable changes, the tax differential against Canadians would be reduced or eliminated by the adoption of the rate schedules we recommend. Where the unfavourable differentials were not eliminated they would be so small in absolute terms that it is difficult to conceive that they would exert a significant influence on the decision to emigrate.

#### The Participation Rate for Married Women

The Canadian labour force could be immediately increased by a substantial amount if more married women were willing to work outside the home. For most married women the decision to work in the home or outside the home is not affected by tax considerations. But those women who believe that the non-tax advantages and disadvantages of working outside the home are about equal probably are deterred from taking a job when marginal rates on the additional family income are high.

TABLE 37-1

DIFFERENTIAL BETWEEN CANADIAN AND UNITED STATES  
PERSONAL INCOME TAXES  
(dollars)

<u>Income</u>	<u>Unattached Individual</u>		<u>Family Without Dependants</u>		<u>Family with Two Children</u>	
	<u>Current</u>	<u>Proposed</u>	<u>Current</u>	<u>Proposed</u>	<u>Current</u>	<u>Proposed</u>
5,000	-36	-13	-58	-109	26	-33
6,500	-15	30	-14	-75	108	27
8,000	18	57	42	-49	150	62
10,000	91	93	195	7	251	112
12,000	144	60	341	-3	418	177
15,000	242	-88	716	1	748	255
25,000	198	-1,230	2,202	-12	2,474	616
40,000	-510	-3,635	3,582	-480	4,780	1,170
70,000	-2,332	-9,150	4,724	-2,932	8,245	1,343
100,000	-4,343	-15,208	5,533	-6,120	12,426	1,873

## Notes:

1. It must be emphasized that these comparisons are based on "income". The definition of income that we propose would differ substantially from the United States definition. Although there would be some difference between the Canadian and United States definitions of employment and professional income, the difference would be relatively small. There would be major differences in the definition of property income. The reader should therefore treat the comparisons as valid for employment and professional income only. It is assumed that standard deductions are claimed in comparisons for taxpayers without dependants and that average itemized deductions are claimed by families with 2 children as described in the notes to Table 11-14 of Chapter 11.
2. The minus sign indicates that Canadian taxes are below United States taxes.
3. These comparisons ignore the premium on the United States dollar.

Source: Chapter 11.



If equity were of no concern the most effective tax method of encouraging the labour force participation of wives would be to impose low marginal rates of tax at the bottom of the schedule, allow husbands and wives to choose not to aggregate their incomes, and allow families to deduct the special expenses incurred when wives work, or provide credits in lieu of these deductions. We are not prepared to recommend that Canada should go this far to encourage the participation of married women in the labour force. In particular, we believe that to achieve the fair allocation of taxes between families, tax liabilities should be determined on the basis of the aggregate income of the members. Not to do so would give an unwarranted advantage to families with two income recipients relative to families with one income recipient.

However, on equity grounds we accept the need for low tax rates at the bottom of the income scale and some recognition of the special costs of families with working wives where there are dependent children. On equity grounds we also accept the proposition that working couples with low incomes should not pay higher taxes than they would pay if they were single. To such people few economies are possible through marriage and there are extra expenses in establishing a household.

As is discussed in Chapter 11, most married women without children would generally find their tax position worsened under the system we propose. Working would be slightly less attractive to them than it is now. Married women with children would find the opposite. Because the proportion of married women with children is larger than the proportion without children we expect that the net effect of the proposed changes would be favourable to the participation of married women in the labour force. This result could be achieved without sacrificing a fair tax system.

#### Education and Training

We have not tried to assess how the government could best encourage more people to take more training and acquire more education. The broader

issues are far outside our terms of reference. However, the present Act does have provisions designed to encourage higher education and training, and we have simply accepted the premise that the tax system should serve this purpose and have made recommendations that would make the tax system both more effective and more equitable in its realization.

Converting the present concession from a deduction to a tax credit would serve the purpose of giving the greatest relief to parents with low incomes or to students with low expected incomes immediately following graduation. High income parents and students are much less likely to need the encouragement.

The recognition of living costs would increase the tax concession to students who were not dependent on their parents.

By allowing unused educational tax credits to be carried forward indefinitely, and by allowing the credit to be transferred between tax units, the proposed tax system would enable students with no current income to borrow to finance their education with the knowledge that they could more easily repay the loan, because their tax liabilities in the first years after graduation would be reduced by the educational credits.

While we cannot be certain that tax concessions provide the most efficient encouragement, adoption of our proposal would, we feel certain, encourage a larger proportion of Canadians to further their post-secondary education and training and would be more equitable than the present concessions.

The extent of the encouragement can be seen from an example. Under the present system, students taking higher education or training are entitled to deduct tuition payments in excess of \$25 in computing taxable income. Assuming that the average student is unmarried, pays tuition fees of \$400, and has part-time earnings of \$2,000, his annual tax liability under the existing system, including old age security tax, is \$64. Under our proposals, if the student was not a member of his parents' tax unit and had

expenses and earnings as assumed, his annual tax credit would be \$400 of which only \$128 would be offset against taxes otherwise payable. Over a five-year period the student would accumulate a total credit of \$1,360 that could be carried forward indefinitely. Assuming the student married on graduation and had an average income in the years immediately following graduation of \$6,000, the student would pay no tax for 2 years. This would make it much easier to repay any loans contracted while he was a student.

#### EFFECTS ON THE ALLOCATION OF FIXED CAPITAL

Increasing future output through an improved allocation of fixed capital, like the increased future output gained from attaining and maintaining full employment, is costless in the sense that no sacrifice of other economic goals is required 3/.

The optimum allocation of a given volume of investment (fixed capital formation) is attained when the marginal rates of return to society on each type of investment are equal. If the marginal rates of return to society are not equal, it is possible to increase the overall rate of return, and hence output, by shifting investment from activities with low marginal social rates of return to activities with high marginal social rates of return 4/.

In general, we rely upon the operation of markets rather than the planning of governments to determine the allocation of investment. To be sure, governments actively intervene in a number of ways, and the tax system has important effects upon the allocation achieved through the market. But by and large, investment decisions remain largely decentralized decisions.

As a point of departure, it is useful to review briefly the conditions under which the operation of markets that co-ordinate the decentralized decisions of private firms and individuals achieve, or come close to achieving, the optimum allocation of savings.



## The Efficiency of Market Allocation

Under competitive market conditions, marginal private rates of return for investments with similar risk are equated. Private rates of return are higher on riskier investments because of risk aversion by investors.

Even under these idealized conditions, market allocation may not be optimum. Some of the costs and benefits to society of investments do not enter private calculations of profit and loss. This is particularly important for investments that would lead to the discovery or embodiment of new technology and for large, indivisible investment projects that have significant effects on related industries. Marginal rates of return on different kinds of investments may not be equated because of the premium required for riskier investments. The risk premium appropriate for the individual firm—particularly a new firm—may overstate the risk for society as a whole because it may be difficult for potential investors to pool their risks. The appropriate risk premium for society therefore may be less than the private risk premium. In addition to these possible imperfections that would exist in an ideal world, investment may be restricted below optimum levels in those industries where the discipline of competitive markets is weak.

The existing capital markets have a number of discriminatory features which may further distort the allocation of investment. Because financial institutions generally are averse to risk, the terms on which credit are available, if it is available at all, to new, small, and other risky enterprises is likely to be stringent. Furthermore, the market attaches liquidity premiums to securities that are readily marketable. This favours large, well-established firms. These discriminatory features of the capital market are mitigated to some extent when firms use internal rather than external sources of funds. In fact, internal sources (capital cost allowances and retained earnings) have provided the bulk of investment funds in the postwar period. However, the use of internal funds itself poses some allocation problems. Investment should be determined on the basis of

expected marginal rates of return, not on the basis of current or previous profits. Even in diversified firms, many investment projects lie outside the purview of the most farsighted manager. New firms and firms in growth industries often cannot rely exclusively on internal sources of funds; they must turn to the capital markets. But there, as we have seen, because of market biases they may not have access to sufficient funds on the terms that would be warranted by the social productivity of the investment.

There is no reason to believe that private markets achieve the optimum allocation of savings. Consequently, a case can be made for government policies designed to correct the market allocation. The fact that private markets do not always achieve an optimum allocation provides an argument against tax neutrality.

It should be obvious from earlier chapters of this Report that the present tax system is not neutral in its impact on the economy. Whether or not the existing departures from neutrality correct for the distortions created by private markets or are the source of further distortion is the crucial question.

What has become apparent to us through our study is that the present tax structure is the result of past crises and revenue requirements and is not a coherent system designed to achieve widely accepted economic and social objectives. It would be surprising if the effect of such a system were to correct rather than worsen the allocation of resources achieved through markets. Indeed, we believe that the latter has occurred. The present tax structure introduces a number of distortions that do not compensate for market distortions. In some cases the tax distortions worsen market distortions already present; in other cases they represent new distortions that further reduce the efficiency with which capital is allocated among alternative investments.

There is no need to review every detail of the existing tax structure that affects the allocation of capital. Instead we shall enumerate only

the more important features.

1. The inadequate allowance for the deduction of business losses.

This is a particularly serious defect, for it lowers the expected after-tax rate of return on risky investments that already are discriminated against in the capital markets.

2. The dual rate of the corporation income tax. This raises the after-tax

marginal rate of return of firms with low profit levels, but is a subsidy to larger firms that does not significantly affect their rate of capital expansion. The 21 per cent rate of tax on the first \$35,000 of corporate income partly compensates for the capital market discrimination against small businesses; however, it does not discriminate between small firms with pressing investment needs and small firms without such needs. It is therefore a most inefficient way of compensating for any capital market discrimination against small firms.

3. The separate corporation income tax itself. The subjection of corporate

source income to tax rates higher than those imposed on non-corporate source income reduces investment in industries where the corporate form of organization is essential and the corporation income tax cannot be shifted.

4. The absence of a tax on capital gains. In part, but only in part, the

failure to tax capital gains compensates for the existence of a separate corporation income tax. However, the combination of the present corporation income tax with no tax on capital gains on shares distorts investment in favour of activities that generate income in the form of capital gains relative to activities that generate income in taxable forms.

The absence of a tax on gains from the sale of other assets, particularly real estate, also stimulates a shift of capital funds toward these activities.



5. Various special industry privileges. A number of industries, in particular mining, petroleum and certain financial institutions, are favoured under the present tax laws. This favourable treatment stimulates investment in these industries or the activities financed by them. Presumably capital moves into these activities until the expected marginal after-tax rate of return is the same in these industries as in industries of comparable risk. When this occurs, the before-tax marginal rates of return to the favoured industries are below those in other industries. Total output is reduced because all capital is not put to best use.

#### A Programme to Improve the Allocation of Capital

It is impossible to devise a tax structure that would achieve the optimum allocation of savings. This is tantamount to demanding that tax policies alone correct for the inadequacies of all other policies and all market imperfections. It would be a mistake, for example, to try to eliminate the consequences of inordinate market power through tax policies when combines policies and commercial policies can attack the heart of the problem. We have therefore attempted to design a tax structure that:

(a) generally achieves neutrality but (b) corrects for certain market distortions where we believe that tax policies, rather than other government policies, are the best means available.

Fortunately, a tax structure designed to achieve horizontal equity also achieves neutrality with respect to industries and activities. Furthermore, there is little reason to believe that a progressive tax system, which achieves vertical equity, is not neutral with respect to the allocation of savings <sup>5/</sup>. It is only when a progressive income tax structure is coupled with loopholes and discriminatory tax treatment of different kinds of income that increased progressiveness leads to increased departures from neutrality.

We now discuss the effect of our proposed tax reforms on the allocation of capital, distinguishing between (a) those aspects of the proposed tax structure which are particularly important to the achievement of neutrality and (b) those features which involve deliberate departures from neutrality designed to offset biases in the market allocation of capital.

The reforms designed to achieve neutrality essentially involve the elimination of those features of the present tax system that cause variations in the relationship between before-tax and after-tax rates of return among industries, types of assets and forms of business organizations. The major reforms of this kind that we recommend are as follows:

1. A more generous treatment of losses. The extension, within feasible administrative limits, of loss offsets against other income would do much to eliminate the tax discrimination against risky ventures.
2. Integration of the personal and corporation income taxes and the full taxation of share gains. This set of reforms would eliminate the concern of corporations and investors for the form in which the income generated from investments accrues. As a result, before-tax and after-tax rates of return on a wide variety of investments would be proportionate, after full adjustment to the tax reforms. As the market operated to equate after-tax rates of return, before-tax rates of return would also be equated. This would bring about a major improvement in the allocation of capital.
3. Taxation of capital gains on other assets. This would induce a shift in investment away from assets presently favoured by the zero rate of tax on capital gains, thereby bringing the before-tax rates of return on these assets into line with before-tax rates of return on other assets.
4. Elimination of the present favourable treatment of the mining and petroleum industries. The present tax treatment tends to induce overinvestment in these industries relative to others. The elimination

of this favourable tax treatment would encourage a shift in investment away from these activities, again bringing before-tax rates of return into line with prevailing rates in other industries.

5. Elimination of the dual rate of corporation income tax. This is a necessary part of the proposed overall reform of the tax treatment of corporate source income. It would have favourable effects on the allocation of capital by eliminating the concession to smaller enterprises that have poor profit prospects and by removing the subsidy to larger enterprises.

Adoption of these major reforms would largely eliminate the principal biases in the present tax system. The tax structure we propose would also help to correct the misallocation inherent in the present market system.

We assign a modest role to tax concessions or departures from neutrality. However, we believe that tax provisions can be particularly useful in offsetting the biases against the new, the unknown and the small that is inherent in the allocation of funds through existing capital markets. In some cases we have decided to recommend a continuation of present non-neutral provisions and in one significant case we have recommended a new provision:

1. The present system of capital cost allowances has an incentive to investment built into it. It is, in effect, a method of accelerated depreciation. The tax reductions resulting from the acceleration of capital cost allowances relative to depreciation amount to an interest-free loan by the government to the taxpayer. Accelerated capital cost allowances are an important source of funds, and reduce the need for external financing by firms with high current investment rates. We believe that the present system is an efficient incentive and should be retained.
2. The immediate write-off of exploration and development expenses of mining and petroleum firms, and the research and development expenses of all firms, should be continued. Exploration and research are necessarily



risky activities. They frequently yield substantial benefits that are greater to society than to those who undertake them. While government programmes and subsidies to exploration and research are an important means of stimulating these activities, we believe that tax policy can play a useful role in encouraging exploration and research by private firms.

3. The immediate write-off of some capital costs for new businesses meeting prescribed maximum size limits should be permitted. This would substantially increase the cash flow of new and small enterprises that are now discriminated against in the capital market.
4. The immediate or accelerated write-off of capital costs and the immediate write-down of the value of the new equities of mining and petroleum corporations would compensate for any capital market bias against these industries.

These measures would help to offset the capital market bias against new firms, small firms and risky ventures. It is also worth mentioning in this connection that the integration of the corporation and personal income taxes, by making it possible to reduce pay-out ratios, would increase the availability of internal funds for use by most domestic corporations. This would further reduce the dependence of growing firms on external sources of funds and would therefore mitigate the capital market distortions referred to above 6/.

#### The Importance of the Improved Allocation of Fixed Capital

As was mentioned earlier in this chapter, the improved allocation of investment is a costless source of greater output. However, it is virtually impossible to measure the contribution to future output that would be made by an improved allocation of fixed capital. To make a reliable overall measure it would be necessary to have information on marginal rates of return in different industries. This information is not available. However, some

indication of the magnitude of the contribution of capital transfers can be inferred.

The marginal tax rate for large corporations not eligible for special tax provisions is about 50 per cent. We estimate that the average effective marginal tax rate for Canadian mining corporations is about 20 per cent 7/.

Assuming that marginal after-tax rates of return are equated in all lines of activity of equivalent risk, and that the marginal before-tax rate of return for most corporations involving roughly the same risk as mining is 20 per cent, it follows that the marginal before-tax rate of return in mining is about 12.5 per cent. This means that shifting a dollar's worth of additional capital from the average mining company to the average fully taxed company would yield an additional before-tax rate of return of about 7.5 per cent. This would have the same effect on output as an increase in the rate of capital formation.

Clearly, changes in the allocation of investment, as distinct from the volume of investment, could have a substantial effect on the output of the economy. Implementation of the changes we recommend, by improving the allocation of capital, would make it possible to sustain the growth rate with less capital formation or attain a higher growth rate with the same capital formation.

In the next three sections we discuss the effects that the adoption of our proposals would have on the rate of business saving and the allocation of fixed capital formation among businesses with different characteristics.

#### ESTIMATES OF THE PROPOSED CORPORATION INCOME TAX CHANGES ALLOCATED BY INDUSTRY, BY TYPE OF REFORM AND BY OWNERSHIP

As discussed in Chapter 35, we estimate that, in the absence of transitional costs, the adoption of our proposals would have increased corporation income tax collections by \$538 million 8/ in 1964, or by approximately 25 per cent. This would take place largely as the result of four changes: the abolition

of the 21 per cent rate of tax on the first \$35,000 of corporate income; the withdrawal of some of the tax concessions now provided the extractive industries; the measurement of the business income of life insurance companies on the same basis as that of other businesses; and the full taxation of the capital gains realized by corporations.

In assessing the probable effects of the suggested tax changes on business saving and investment (gross fixed capital formation) it is important to recognize that not all businesses would be affected in the same way. The direction and magnitude of the effects of the changes in the tax would depend upon the form of business organization, the level of business income, the extent of non-resident ownership of the business, the industry of which the business was a part, and the income levels of the resident owners of the business. Because we are primarily concerned with the net effect of all of these diverse changes it is essential that an attempt be made to quantify the impact, for only then can an impression be obtained of the extent to which the changes would offset one another.

The estimates given in Tables 37-2 and 37-3 show the proposed tax increases classified by industry, by ownership and by reform. Like the estimates given in Chapter 35, these estimates relate to 1964. Transitional costs are ignored. The estimates are, in part, based on crude assumptions, for all of the data needed to make precise estimates are not available. The estimates take into account only the direct effects of the proposed tax changes and do not reflect any adjustments that would occur following the radical changes in the tax system we recommend. Specifically, no attempt has been made to adjust the estimates for any shifting of the corporation income tax changes in either direction through changes in prices or costs; no attempt has been made to adjust for any impact that the tax changes would have on the level of economic activity; no attempt has been made to reflect the effect that the improved allocation of capital would have on business income.



TABLE 37-2

**ESTIMATED CHANGES IN THE PAYMENT OF CORPORATION INCOME TAX, RESULTING FROM THE PROPOSED REFORMS  
CLASSIFIED BY INDUSTRY, FOR CORPORATIONS REPORTING A PROFIT IN 1964<sup>a</sup>**  
(millions of dollars)

	Number of Corporations	Proposed Change in the Tax Base		Total Tax Declared <sup>c</sup>		Proposed Changes in Tax					Proposed Tax		Capital Expenditures			
		Current Taxable Income <sup>b</sup>	Proposed Tax Base	Amount	Percent- age of the Current Taxable Income	Amount	Percent- age of the Current Taxable Income	Percent- age of the Current Taxable Income	Removal of Major Conces- sion	Other <sup>g</sup>	Total	Percent- age of Present Tax	Amount	Percent- age of the Proposed Tax Base	Amount	Industry as Per- centage of Total Capital Expenditure
Industries without major special concessions																
Agriculture, forestry and fishing.....	2,079	35	38	3	9	12	33	31	6	1	7	58	19	54	36	1
Manufacturing <sup>d</sup> .....	14,249	1,934	1,975	41	2	905	47	46	61	21	82	9	988	51	1,388	43
Construction.....	9,364	124	105	-19	-15	37	30	35	25	-9	16	43	53	42	50	137
Transportation, storage and other utilities.....	3,894	498	501	3	1	239	48	48	10	2	12	5	251	50	680	21
Wholesale and retail trade.....	28,199	673	668	-5	-1	257	38	39	80	-3	77	30	334	50	324	10
Finance, insurance and real estate (excluding life insurance but including general insurance and banks) <sup>b</sup> .....	18,166	614	698	84	14	257	42	37	49	43	92	36	349	57	215	7
Services.....	10,502	139	132	-7	-5	46	33	35	24	-4	20	44	66	47	210	6
Total.....	86,453	4,017	4,117	100	2	1,753	44	43	255	51	306	17	2,059	51	2,991	92
Industries with major special concessions																
Mining (including prospecting and contract drilling).....	568	233	501	268	115	117	50	23	-	3	133	114	251	108	145	4
Oil and natural gas (including petroleum refineries).....	188	93	131	38	41	47	50	36	-	19	19	40	66	70	111	3
Life insurance.....	- e 4	154	150	-4	-	2	50	1	-	75	75	3750	77	1925	50	- i
Total.....	756	330	786	456	138	166	50	21	-	224	3	227	137	393	256	8
All industries, active taxable corporations (excluding co-operative and crown corporations).....																
	87,209	4,347	4,902	556	13	1,918	44	39	255	224	54	533	28	2,451	56	3,247
Inactive corporations, co-operatives and crown corporations.....	7,612	39	44	5	13	17	44	39	3	-	5	29	22	56	50	- j
Total taxable corporations.....	94,821	4,386	4,946	561	13	1,935	44	39	258	224	56	538	28	2,473	56	-

Notes: <sup>a</sup> Unless otherwise stated, the industry classification and amounts have been summarized from preliminary tables provided to us by the Department of National Revenue from the 1966 *Taxation Statistics*, Part Two. The table includes only taxable corporations. Tax-exempt corporations are excluded, as are 60,256 loss corporations.

<sup>b</sup> Current taxable income is after deduction of prior years' loss.

<sup>c</sup> Total tax declared is the income tax payable before abatement for provincial and foreign income taxes paid; old age security tax is included. Because the amount of tax declared includes the provincial income taxes collected by the federal authorities for all provinces other than Quebec and Ontario, it represents slightly more than the prescribed 21 per cent on the first \$35,000 of taxable income and 50 per cent on the balance, because of an additional 1 per cent levied by Manitoba and Saskatchewan.

<sup>d</sup> Petroleum refineries have been included with oil and natural gas and not in their regular manufacturing classification as substantial depletion is claimed by corporations classified as refiners.

<sup>e</sup> The number of life insurance companies reporting a profit has not been separated from the aggregate figure for all banks and insurance companies.

<sup>f</sup> Because *Taxation Statistics* do not show separately the amounts for life insurance companies, we have based our estimates on figures contained in the *Report of the Superintendent of Insurance for Canada, 1964*, Volume I, and on information supplied by the Department of Insurance. We did not attempt, however, to show separately the number of life insurance companies reporting taxable income.

<sup>g</sup> In the case of the industries without major concessions this figure includes the three-year exemption for new mines and depletion claimed on income from mining or petroleum. This amount is only significant for corporations classified as iron and steel mills within the manufacturing group.

The two major proposals included in "other" are the full taxation of capital gains and the more liberal treatment of losses. Other additions to income resulting from the comprehensive tax base and the effect of the proposals to encourage capital formation in new and small businesses are also reflected. The proposed treatment of losses and new and small businesses would result in a net reduction in the tax base for some industries.

<sup>h</sup> On depreciable fixed assets only. Includes preproduction expenses for mining and petroleum corporations.

<sup>i</sup> Not reported separately, so included with finance, insurance, and real estate.

<sup>j</sup> Not reported.

Totals do not add due to rounding.

TABLE 37-3

**ESTIMATED CHANGES IN THE PAYMENT OF CORPORATION INCOME TAX IN 1964, CLASSIFIED BY INDUSTRY, a/**  
**BY KIND OF REFORM AND BY RESIDENT AND NON-RESIDENT OWNERSHIP,**  
**RESULTING FROM OUR PROPOSED REFORMS**  
(millions of dollars)

	Total Proposed Changes in Payments of Corporation Income Tax b/	Attributable to Residents			Attributable to Non-Residents c/			Percentage of Total Tax Change Attributable To Residents
		Dual Rate	Removal of a Major Concession		Dual Rate	Removal of a Major Concession		
			\$	\$		Other	Total	
Industries without major special concessions:								
Agriculture, forestry and fishing	7	5	—	1	1	—	—	1
Manufacturing	82	32	—	9	41	—	12	41
Construction	16	19	—	(9)	10	—	—	50
Transportation, storage and other utilities	12	7	—	2	9	—	—	62
Wholesale and retail trade	77	59	—	(3)	56	—	—	67
Finance, insurance and real estate (excluding life insurance)	92	33	—	19	52	—	24	73
Services	20	19	—	(4)	15	—	—	57
Total	306	174	—	15	189	—	36	75
Industries with major special concessions:								62
Mining and quarrying	133	—	26	1	27	104	2	20
Oil and natural gas	19	—	4	—	4	—	—	15
Life insurance	73	—	42	—	42	33	—	33
Total	227	—	72	1	73	152	2	56
Inactive corporations, co-operatives and crown corporations	5	3	—	2	5	—	—	32
Total taxable corporations	538	177	72	18	267	152	38	100
								50

Notes: a/ Classifications by industries are the same as in Table 37-2 and the same notes apply. Columns may not add to totals due to rounding.

b/ From Table 37-2.

c/ In arriving at these estimates we made use of material published in the Report for 1962, Corporations and Labour Unions Returns Act and The Canadian Balance of International Payments 1961 and 1962 and International Investment Position, and of data supplied to us by the Dominion Bureau of Statistics and Department of National Revenue. The division between resident and non-resident will not therefore correspond to the general ownership proportions as published as we made adjustments to reflect the impact of our proposals on a number of large corporations in which the share ownership did not necessarily correspond to the average for the industry.

These qualifications mean that the reader should interpret the estimates only as an indication of the relative orders of magnitude that would prevail about 5 to 10 years after the introduction of the proposed system in the absence of any indirect effects.

From these estimates it is apparent that:

1. Nearly half of the estimated increase in the corporation income tax would be attributable to the withdrawal of the dual rate of corporation income tax.
2. Aside from the withdrawal of the dual rate, corporations in industries without special industry tax concessions would not be subject to significant increases in corporation income tax.
3. The extractive industries and life insurers would be subject to relatively large tax increases as a result of removing the special tax concessions that they now enjoy.
4. The tax increases would constitute a substantial proportion of the capital expenditures in some industries.
5. A large part of the corporation income tax increase would apply to income attributable to non-residents.

The implications of these changes can be summarized briefly:

1. Withdrawal of the dual rate would have no effect on the marginal rate of return and no significant effect on cash flow for corporations with incomes of over \$200,000. These corporations account for approximately 70 per cent of total corporate income. Corporations with lower incomes that were increasing their capital investment rapidly would obtain, through the adoption of our accelerated write-off proposal, an equally effective and more efficient concession. Low income corporations with low income resident shareholders would not be worse off because of the integration proposal as they would have the option of being taxed as a partnership.



Low income, stagnant corporations with high income resident shareholders would be worse off, but this would not have a significant effect on the rate of capital formation.

2. A few large integrated <sup>9/</sup> mining and petroleum corporations would be adversely affected by the adoption of our proposals. The cash flow of these corporations would decline by about 10 per cent and their cash flow rate of return would fall by as much as 25 per cent. The rate of capital formation by these corporations would probably decline. Non-integrated corporations in the extractive industries that were expanding generally would not be adversely affected because the accelerated capital cost allowances would continue to eliminate the tax otherwise payable, at least until they completed the expansion of their capital investment. In addition, resident shareholders of most corporations would not be adversely affected by these corporation income tax changes, at least initially, because with the full credit for the corporation income tax, tax reductions at the shareholder level would more than compensate for the increases at the corporate level. However, the full taxation of realized share gains would adversely affect these shareholders.
3. The taxation of non-resident-owned general insurance corporations in the same manner as resident companies would have little impact because most of the non-resident shareholders would obtain credit for the Canadian tax increase against their domestic taxes. However, life insurance corporations would have a substantially reduced cash flow. This would mean that these companies would have reduced funds available to finance business and government.
4. With the exceptions noted above, the resident shareholders of high income corporations would greatly benefit from the proposed tax changes. The integration of personal and corporation income taxes would reduce the cost of equity capital to the corporation and would encourage a more rapid rate of capital expenditure. The positive effects of integration would

not be offset by the negative effects of the full taxation of share gains.

5. On the basis of the estimates available to us (admittedly subject to a wide margin of error), we believe that the more rapid rate of capital formation by these corporations would at least offset the reduced rate of capital formation brought about by the proposed increases in taxes for integrated mining and petroleum corporations, life insurance corporations and low profit, slow growth corporations owned by high income resident shareholders.

In support of these conclusions we analyze below the impact of our proposals on large 10/ resident-owned corporations that do not have special industry concessions. The implications for other kinds of businesses are discussed later.

EFFECTS ON THE RATE OF SAVING AND CAPITAL FORMATION  
BY LARGE RESIDENT-OWNED CORPORATIONS  
WITH NO SPECIAL TAX CONCESSIONS

Adoption of our recommendations would neither change the marginal rate of tax imposed at the corporate level on the income from additional investments made by these corporations nor would it significantly alter the base to which these rates would apply. The expected after-tax rates of return to the corporation from additional capital expenditures would be approximately the same as at present. This follows because the capital cost allowance rates of such corporations would not be changed; abolition of the dual rate would not affect the marginal tax rate; these corporations rarely acquire productive assets with the expectation of

realizing a gain on disposition; any effect on expected profit resulting from taxing property gains would be more than offset by removing the limitation of the write-off of losses.

The after-tax income received by many resident shareholders from these corporations would, however, be significantly changed.

#### Effects on the After-Tax Income of Resident Shareholders

The following recommendations, in particular, would alter the after-tax income to residents from these shares:

1. Integration of corporation and personal income taxes would mean that each shareholder would include in income the before-tax corporate earnings allocated to him and would receive full credit for the tax paid on these earnings at the corporate level.
2. Realized goodwill gains (share gains in excess of earnings retained) would be included in the income of the shareholder like other income.
3. Other recommended changes in the definition of income, that is, changes in the treatment of income other than from corporate sources, would increase the tax bases of most upper income shareholders.
4. New schedules of personal income tax rates would be used with a system of credits to replace some of the present exemptions.

Providing full credit for corporation income taxes and lower marginal personal rates would reduce taxes; the full taxation of realized share gains and the inclusion in income of allocated corporate earnings other than cash dividends would substantially broaden the base. Increasing the base means that taxpayers would be pushed further up the personal rate schedule. Many of the other personal income base changes would have a similar effect. Whether the



lower marginal personal rates and the system of tax credits would offset the effect of the broader base would depend upon the particular circumstances of the taxpayer.

It is possible to calculate the changes in direct (personal plus corporation) income tax liabilities that would result from the adoption of our proposals under simplifying assumptions. These are that: income is derived exclusively from holding and disposing of shares in typical, widely held Canadian corporations; goodwill gains equal corporate retentions which in turn equal cash dividends; 11/ tax changes are not shifted 12/. For a childless couple the change in taxes and the change in average and marginal tax rates that would be brought about by the adoption of our proposals are given in Table 37-4. Similar examples for taxpayers in different family situations are provided in Appendix M to Volume 4. It should be noted that under these assumptions corporate source income defined in accordance with the comprehensive tax base is approximately five times cash dividends. That is to say, if a shareholder received cash dividends of \$5,000 his comprehensive tax base would be approximately \$25,000.

These calculations make it clear that, under the stated assumptions, most shareholders would obtain substantial tax reductions with respect to Canadian corporate source income despite the great broadening of the base. Only taxpayers with extremely large incomes would be subject to tax increases, and these tax increases would be relatively small. For the type of corporations under consideration these net tax changes would result from small increases in corporation income tax collections and large reductions in personal income tax collections for lower and middle income taxpayers, and some increases in personal income taxes paid by taxpayers with comprehensive incomes over \$100,000.

Few taxpayers in fact derive all of their income from corporate sources. To assess what the changes in average and marginal rates of tax on Canadian shareholders of these large corporations would have been in 1964, estimates were made of these changes based on assumptions about the actual composition of income in that year using the sample of 417,000 tax returns discussed in

ESTIMATED CHANGES IN PERSONAL AND CORPORATION INCOME TAXES RESULTING FROM  
OUR PROPOSED REFORMS FOR A RESIDENT, CHILDLESS COUPLE WITH INCOME DERIVED  
EXCLUSIVELY FROM A TYPICAL CANADIAN PUBLIC CORPORATION

Comprehensive Income, a/ \$	Tax Liabilities			Average Tax Rate			Marginal Tax Rate		
	Under the Current System \$	Under the Proposed System \$	Change \$	Under the Current System %	Under the Proposed System %	Change %	Under the Current System %	Under the Proposed System %	Change %
2,000	789	0	-789	0.394	0.000	-0.394	0.399	0.091	-0.308
3,000	1,183	111	-1,072	0.394	0.037	-0.356	0.399	0.157	-0.242
4,000	1,577	269	-1,308	0.394	0.067	-0.327	0.399	0.178	-0.221
5,000	1,971	448	-1,523	0.394	0.090	-0.305	0.399	0.189	-0.210
8,000	3,154	1,037	-2,117	0.394	0.130	-0.265	0.399	0.209	-0.190
10,000	3,934	1,457	-2,486	0.394	0.146	-0.249	0.401	0.219	-0.182
12,000	4,714	1,896	-2,818	0.395	0.158	-0.237	0.407	0.238	-0.169
15,000	5,951	2,615	-3,336	0.397	0.174	-0.222	0.407	0.267	-0.140
20,000	7,963	3,964	-3,999	0.398	0.198	-0.200	0.407	0.306	-0.101
30,000	11,948	7,260	-4,688	0.398	0.242	-0.156	0.399	0.377	-0.022
40,000	15,890	11,058	-4,832	0.397	0.276	-0.121	0.399	0.416	+0.017
50,000	19,833	15,256	-4,577	0.397	0.305	-0.092	0.399	0.438	+0.039
70,000	27,755	24,254	-3,501	0.396	0.346	-0.050	0.439	0.460	+0.021
100,000	40,948	38,653	-2,296	0.409	0.387	-0.023	0.450	0.499	+0.049
200,000	86,086	88,652	2,566	0.430	0.443	-0.013	0.460	0.500	+0.040
350,000	156,167	163,652	7,485	0.446	0.468	-0.021	0.480	0.500	+0.020
600,000	267,374	288,652	12,278	0.461	0.481	-0.020	0.490	0.500	+0.010
1,000,000	474,161	488,652	14,491	0.474	0.489	-0.014	0.500	0.500	0.000

Note:

a/ Comprehensive income includes accrued goodwill gains equal to cash dividends and all before-tax corporate earnings that are assumed to be allocated to shareholders as they accrue.

Source: Appendix M to Volume 4.

Appendix B to this Volume 13/. These estimates do not differ significantly from the estimates shown in Table 37-4.

Under the system we propose the taxable gains from holding or disposing of assets other than Canadian equities would be unchanged or increased. The after-tax income from Canadian equities would therefore increase relative to the after-tax income from other assets. This would increase the Canadian demand for Canadian equities and reduce the demand for other assets. Equity prices would rise and the prices of other assets would decline from what they otherwise would have been. Equity prices would rise until the marginal investor 14/ was obtaining the same after-tax return from equities that he was able to obtain from other assets of comparable risk. If the after-tax return from a riskless bond was 4 per cent, and the marginal investor demanded a risk premium of 4 per cent on the after-tax return from shares in a typical public company, the market price of the shares of such a company would rise until they yielded an expected after-tax income to this investor of 8 per cent. At this capitalization rate 15/ a share that was expected to yield \$10 a year after tax to the marginal investor would have a market value of \$125. Assuming that the capitalization rate did not change as a result of our proposed tax changes, and that the expected after-tax income 16/ from a share in a typical public company held by a marginal investor increased by 25 per cent, the share price would rise by 25 per cent. This is readily illustrated by the following example.

	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Percentage Increase</u>
Annual expected after-tax earnings per share to the marginal investor	\$10.00	\$12.50	25
Market price of a share based on a discount rate of 8 per cent	\$10.00/.08 = \$125.00	\$12.50/.08 = \$156.25	25

It is not possible to say how great would be the increase in the relative price of equities. The capitalization rate might change, depending upon the elasticities of demand for different kinds of assets by different income groups



and upon the extent to which changes in the expected after-tax income from these assets would change the demand for each kind of asset by each income group. These changes would depend, in part, on the attitudes toward risk of investors in different income groups. The marginal investor in the market after the effects of our proposals had been capitalized in changed market prices probably would not be the marginal investor of today. However, because of the nature of the changes we propose and their effect upon the demand for other assets, we do not expect that capitalization rates would change materially 17/.

Thus far we have spoken only of the effects of the higher after-tax income from equities to resident individuals. The recommended treatment for the corporate source income of life insurance companies and Registered Retirement Income Plans could have an even more dramatic impact. A large part of the saving of low and middle income individuals and families is made through the payment of life insurance premiums and through contributions to pension plans. At the present time the intermediaries that invest these large flows of funds are not entitled to the dividend tax credit. The after-tax rate of return from equities to these institutions is lower, relative to the after-tax rate of return from other assets, than it is for other resident investors. Because this discrimination does not prevail in the United States it may partially explain why equities constitute a smaller proportion of the portfolios of these institutions in Canada than they do for similar institutions in the United States. It must be admitted, however, that their desire to avoid risk may have been of equal or greater importance. Providing these institutions with the full credit for underlying corporation income tax and in the case of Registered Retirement Income Plans, not taxing their realized share gains, would bring about a major change in the relative attractiveness of equities to these investors. The net cash flow from equities would be approximately tripled for the trustees of Registered Retirement Income Plans. We believe that the adoption of the recommended treatment of these savings institutions would greatly increase their demand for Canadian equities and contribute to higher prices for common and preferred shares.

Reducing the taxes on the income from equities would result in capital gains to those who held shares at the time the tax change was made, or anticipated, and corresponding capital losses to those who held other assets. As we state in Chapter 19, from the viewpoint of equitable taxation these capital gains and losses would be an undesirable but inescapable result of any change in taxes on the returns from assets. It is the effect of these higher equity prices on the rate of fixed capital formation by one type of corporation, rather than the question of taxpayer equity during the transitional period, in which we are interested in this chapter.

#### Effect on the Rate of Fixed Capital Formation

Shareholders may supply a corporation with additional funds either through the purchase of new shares or by "allowing" the corporation to re-invest some or all of its after-tax earnings 18/. With these funds the corporation may undertake new projects or expand existing ones. Shareholders will be better off as a result of the acquisition of additional assets by the corporation financed in either way if the present value to them of the expected after-tax income stream generated by the additional assets is greater than the present value of the expected after-tax income stream that the shareholders could have obtained had the funds been invested with the same risk outside the corporation.

Assuming that the rate at which after-tax corporate source income is capitalized by shareholders remained the same, reducing the tax burden on this kind of income means that it would then be in the interest of shareholders for corporations to undertake projects with lower before-tax rates of return than would have been attractive before the tax change. To illustrate what is involved, consider an unlevered corporation, that is, a company with no borrowing against equity, which has an expected perpetual annual earnings stream before-tax of \$1 million, and is owned by resident shareholders all with personal marginal tax rates of 40 per cent both before and after

implementation of our proposals. It is assumed that all earnings are distributed and that the after-tax income to shareholders is capitalized at 8 per cent. Ignoring a multitude of complexities, 19/ the value of the shares under the present and proposed systems would be as shown in Table 37-5.

TABLE 37-5

ILLUSTRATION OF THE EFFECT OF OUR PROPOSALS  
ON THE MARKET VALUE OF A CORPORATION  
(thousands of dollars)

	Under the <u>Current System</u>	Under the <u>Proposed System</u>
Expected earnings before tax	1,000	1,000
Corporation income tax	<u>490 a/</u>	<u>500 a/</u>
Expected earnings after corporation income tax	510	500
Personal income tax (assuming allocation of all earnings)	<u>102 b/</u>	<u>-100 b/</u>
Expected earnings after personal income tax	<u><u>408</u></u>	<u><u>600</u></u>
Aggregate market value of shares	<u><u>5,100</u></u>	<u><u>7,500</u></u>

## Notes:

a/ Corporate income is assumed to be fully subject to corporation income tax under the present tax system at a rate of 21 per cent on the first \$35,000 and at a rate of 50 per cent on the remainder. Under the proposed system a uniform rate of 50 per cent would apply.

b/ Dividends received by individuals are assumed to be currently taxed at a personal rate of 40 per cent less a dividend tax credit of 20 per cent. Under our proposals all corporate earnings would be taxed at personal rates assumed to be the same 40 per cent. Because corporation income tax would be levied at a uniform 50 per cent rate this would result in a refund of \$100,000 to the shareholders of the corporation.

Assuming that there were a million shares outstanding the price per share would rise from \$5.10 to \$7.50 as a result of the tax change, an increase of almost 50 per cent.



Let us assume that the corporation is considering a new project that would have a capital cost of \$500,000, and that this is to be financed through the sale of additional shares at the prevailing market price. Under the present system the project would have to generate an annual before-tax earnings stream of \$100,000, that is, a before-tax rate of return on the investment of 20 per cent, to avoid dilution of earnings 20/.

Why this is so can be readily explained. To raise \$500,000 the corporation would have to sell 100,000 additional shares at \$5.10 per share, assuming that issue costs amounted to \$10,000. This would be a 10 per cent increase in the volume of shares outstanding. To avoid dilution, before-tax corporate earnings also would have to rise by 10 per cent, or \$100,000. This could be achieved only if the \$500,000 in additional assets earned \$100,000 before tax.

Under the proposed system, given the increase in share prices that we have assumed, net proceeds of \$500,000 (after issue costs of \$10,000) could be raised through the sale of 68,000 additional shares at a price of \$7.50 per share. The volume of shares outstanding would rise by 6.8 per cent rather than by 10 per cent. Earnings would not be diluted if, as a result of the \$500,000 in capital expenditures, before-tax corporate earnings rose correspondingly, an increase of \$68,000. This would require that the additional assets earn a before-tax return of 13.6 per cent rather than 20 per cent.

Clearly the lower limit to the expected before-tax rate of return from additional corporate assets that must be achieved if shareholders are not to be worse off would have declined as a result of the higher price for shares. We shall use the term "cost of capital" to denote this lower limit.

The story is essentially the same, although more complex, if the corporation finances a new project through the retention of earnings. The shareholders would be as well off or better off as a result of the retention of earnings rather than their distribution only if share prices rose by at least

the same amount as the after-tax income that the shareholder could have received had the earnings been distributed. Under the present system, given the assumption we have made above, if the corporation retained \$500,000 of its after-tax earnings, the shareholders would be equally well off only if the shares, in aggregate, rose in value by \$400,000. This would occur only if the present value of the expected after-tax income stream to the shareholders from the additional assets was \$400,000. With a capitalization rate of 8 per cent the \$500,000 of retained earnings would have to generate an expected, perpetual after-tax income stream to shareholders of \$32,000 a year. With a marginal corporation income tax rate of 50 per cent and an effective marginal personal income tax rate of 20 per cent on the balance (after allowing the dividend tax credit), before-tax corporate earnings from these assets would have to be \$80,000. A before-tax return of 16 per cent would thus be required on the \$500,000 investment.

Under the proposed system, if the hypothetical corporation retained all of its after-tax corporate earnings but allocated them to shareholders for tax purposes, the shareholders, in aggregate, would obtain a tax refund of \$100,000. 21/ The \$500,000 retained would therefore have to generate an expected income stream with a present value of \$500,000 if they were not to be worse off; shareholders would then receive a total gain of \$600,000 consisting of \$100,000 in the form of tax refunds and \$500,000 in the form of share gains 22/. At a capitalization rate of 8 per cent, additional annual after-tax earnings for shareholders of \$40,000 would be required. With a combined corporation and personal income tax rate of 40 per cent, additional corporate earnings before tax from these additional assets would have to be \$66,666. This means that a before-tax rate of return on corporate assets of 13.3 per cent would be necessary in order that the shareholders be as well off with the retention as with the distribution. This can be compared with the 16 per cent cost of retained equity capital required under the present system.

The reduction in the required before-tax rate of return on corporate assets under the proposed system is less when we compare projects financed through retained earnings rather than projects financed through new issues. This comes about because under the present system it is possible to avoid personal income taxes through the retention of earnings. Integration would therefore provide a smaller tax reduction for corporations that currently retain a high fraction of their earnings.

While there are intercorporate and intershareholder differences, and we do not wish to underrate them, the main point we seek to make is that we are recommending tax changes that would raise the after-tax income from equities and leave the after-tax income from other assets unchanged or reduced for most investors. Because the after-tax income from equities would be raised this would reduce the minimum expected before-tax rate of return on additional corporate assets that would be in the interest of shareholders. In other words, it would reduce the cost of capital to such corporations.

To put the matter more positively, with the adoption of our recommendations, corporations of the type under discussion would best serve the interests of their shareholders by increasing their rate of fixed capital formation.

The available evidence on the responsiveness of investment to changes in the cost of capital suggests that capital expenditures would be significantly increased 23/.

The effect on capital formation of the reduction in capital costs would be enhanced by other effects of our proposals on decisions made by corporation managers seeking to increase corporate cash flow. Indeed, from the viewpoint of managers not particularly concerned with shareholder interests but desiring to increase the size and importance of the corporation, our proposals have implications for dividend policy. Because our proposals would result in increased cash flow for resident shareholders, pressures for dividend



payments might be substantially lessened, so that more cash for expansion could be retained without creating shareholder dissatisfaction.

#### Financing an Increased Rate of Fixed Capital Formation

After adoption of our proposals the managements of large, resident-owned Canadian corporations that do not now have special industry tax concessions would find that their shareholders would benefit by increased rates of capital formation. Some projects would become attractive that previously would have been rejected because the after-tax rate of return would have been too low relative to the after-tax rates of return that shareholders could obtain elsewhere. The cost of equity capital would fall so that the minimum acceptable before-tax rate of return from a project would be reduced. As a result of the tax changes we propose, proceeding with a number of projects that would be marginal or worse under the existing tax structure would increase the market value of the shares of the corporation by more than the dollars retained, if financed through retentions, or by more than the dollars raised in the capital market, if financed through new issues.

We now consider briefly how this more rapid rate of capital expenditure would be financed. As a starting point we will make some extreme assumptions that later will be modified.

In a world with neither taxes nor market imperfections shareholders would be essentially indifferent about the leverage exerted by corporations 24/. If the corporation was unlevered the shareholder could lever his investment in the corporation by borrowing to finance the purchase of more shares. If the corporation was levered, because of the greater risks the shareholder could not borrow or would not be willing to borrow as much against his investment in the shares of the corporation to finance the purchase of additional shares.

As is illustrated by the calculations shown in Table 37-6, the present tax system introduces a bias in favour of debt financing. Because interest

TABLE 37-6

ILLUSTRATION OF THE BIAS IN FAVOUR OF DEBT FINANCING UNDER THE PRESENT TAX SYSTEM  
(dollars)

Assumptions:	1) Additional corporate assets required: \$1 million																		
	2) Before-tax annual return to corporation from these assets: \$200 thousand																		
	3) Equity can be levered 1:1 at an interest rate of 6 per cent by the corporation or by the shareholder																		
		<u>World With No Taxes</u>																	
		Unlevered	Levered			Unlevered	Levered			Unlevered	Levered			Unlevered	Levered			Unlevered	Levered
Corporation																			
	Raised through sale of shares	1,000	500			1,000	500			1,000	500			1,000	500			1,000	500
	Raised through sale of bonds	—	500			—	500			—	500			—	500			—	500
	Earnings before interest and taxes	200	200			200	200			200	200			200	200			200	200
	Earnings after interest and before taxes	200	170			200	170			200	170			200	170			200	170
	Earnings after interest and taxes	200	170			200	170			100	85			100	85			100	85
Shareholder																			
	Cost of shares	1,000	500			1,000	500			1,000	500			1,000	500			1,000	500
	Financed through loan	500	—			500	—			500	—			500	—			500	—
	Shareholder's investment	500	500			500	500			500	500			500	500			500	500
	Dividends	200	170			200	170			100	85			100	85			100	85
	Interest cost	30	—			30	—			30	—			30	—			30	—
	Dividends less interest cost	170	170			170	170			70	85			70	85			70	85
	Personal income tax (current system)																		
	Tax at marginal rate of 40 per cent																		
	Less: dividend tax credit																		

is deducted by the corporation in computing income for tax purposes, the return to the shareholder is greater when the leverage is applied at the corporate level than when it is applied at the shareholder level. The adoption of the proposed system would restore neutrality between debt and equity financing. Because most corporations can, in fact, borrow more cheaply and readily than most shareholders, the shareholder would not, in fact, be as indifferent to debt/equity ratios under the proposed system as the hypothetical example would suggest. This market imperfection would tend to sustain debt/equity ratios. There are three more reasons why the reliance on debt would be unlikely to decline precipitously:

1. Dividend-paying corporations that finance expansion through the sale of new equities or the retention of earnings generally must increase the total cash dividends paid if a decline in share prices is to be averted. As is illustrated in Table 37-7, unless the dividend rate is substantially less than the interest rate the funds available to the corporations are less when the expansion is financed through the issuance of equities than when it is financed through the issuance of debt 25/. Because management usually wishes to retain earnings to the maximum extent consistent with no reduction in share prices, when debt financing has this cash flow advantage over equity financing there is a pressure to finance through the issuance of debt despite the increased risk. Adoption of our proposals would not remove this advantage, for interest payments would continue to be deductible for corporation income tax purposes.
2. Under some circumstances debt financing confers advantages with respect to the maintenance of control and these advantages would not be affected by the adoption of the system we propose.
3. At the present time, because dividends are not taxable when received by a corporation, the cost of funds borrowed to purchase shares of other corporations is not deductible. A holding company therefore cannot



TABLE 37-7  
ILLUSTRATION OF THE GREATER RETENTIONS POSSIBLE WHEN EXPANSION IS  
FINANCED THROUGH BORROWING RATHER THAN THROUGH THE ISSUE OF NEW SHARES  
(millions of dollars)

Assumptions:	Shares outstanding have a market value of \$100		
	Dividend per share: \$5.00 before and after new share issue		
	Interest on borrowed funds: 6 per cent		
	New project requires \$10 million		
	Expected before-tax return on project: 20 per cent		
	Marginal corporation income tax rate: 50 per cent		
		<u>Financed Through Sale of Bonds</u>	<u>Financed Through Sale of Equities</u>
Funds raised through sale of 100,000 shares or bonds at \$100	10.0	10.0	10.0
Before-tax income from project	2.0	2.0	2.0
Income after interest and before tax	1.4	1.4	2.0
Income after interest and taxes	0.7	0.7	1.0
Income after interest, taxes and dividends	0.7	0.7	0.5

deduct the interest on funds borrowed to gain control of another company. Under the proposed system, because the gains on shares would be taxable to the corporation, these interest costs would be deductible. We expect that removal of this tax barrier would bring about an increase in borrowing by some large corporations.

In summary, removing the tax advantage that is conferred by debt financing would be likely to reduce the relative importance of debt in financing new projects. Reducing the cost of equity financing relative to debt financing would also induce a substitution of equity for debt financing until a new equilibrium had been established 26/. However, in some cases the cash flow (after dividends) advantage to the corporation of debt financing would remain, as would the control advantage. Removal of the present barrier to debt financing of share acquisitions by corporations, that is, the non-deductibility of interest on such debt, would also stimulate borrowing by some corporations. These considerations would tend to sustain present debt/equity ratios. However, on balance we would expect a slight, gradual reduction in the degree of reliance on debt.

In a world without taxes and without issue costs, and where maintaining control was not a factor, shareholders would be indifferent as to whether a corporation raised equity capital through new issues or through the retention of earnings, other things being equal. Over time, the return would be the same to a shareholder who held the shares of a corporation that retained its earnings and to a shareholder who held the shares of the corporation that distributed earnings and financed the same investments through new issues, assuming in the latter case that the shareholder ploughed back all of his dividends to purchase additional shares. The primary difference between the two situations would be that in the case of the corporation retaining earnings to finance expansion, those shareholders who did not wish to reinvest in the same corporation would be obliged to realize their income through the periodic sale of some shares. In the case of the corporation financing

through new issues, shareholders would have a cash flow from the corporation that they could use to purchase the new shares of the corporation, or other assets, or consumer goods.

Because there are costs associated with the issuance of new shares, this neutrality would not prevail completely even in a world without taxes. The return to shareholders would be somewhat greater when corporate expansion was financed through retentions because of the elimination of underwriting commissions and other issue costs, even assuming new equities to be sold through the issuance of rights.

The present tax system substantially increases the capital market bias in favour of retentions. Distributed earnings are taxed to the corporation and also to the shareholder. Retained earnings are only taxed to the corporation. In widely held corporations the shareholder can realize the retained earnings without the payment of personal income tax because the share gain resulting from the retention of earnings is not taxed. Retained earnings thus provide a shelter from personal income tax under the present system. Under the system we propose, this tax shelter would be eliminated 27/.

Despite the removal of the tax bias in favour of cash retentions we do not envisage an increase in the proportion of after-tax income distributed by the type of corporation under consideration. We base this forecast on four factors:

1. Issue costs would continue to encourage equity financing through retentions rather than new issues.
2. The reduction in personal tax on corporate source income would increase the cash flow to low and middle income shareholders, even in the face of all of our other proposed changes. Management could reduce the rate of increase of cash dividends without adversely affecting the cash position of those shareholders who would be most likely to object.



3. Many corporate managements now look upon retained earnings as the preferred method of financing expansion. This attitude is unlikely to change with the implementation of the proposed system.
4. At least part of the bias in favour of debt financing would be removed.

With a reduction in the cost of equity capital relative to the cost of debt, corporations with the characteristics we are discussing would want more equity capital. Given that funds obtained through retained earnings are cheaper than funds obtained through new issues, it would be surprising if their pay-out ratios increased. In our view the effects of the removal of the tax shelter advantage of retentions would be more than offset by the effects of the lower costs of equity capital. To finance their increased rate of investment and a slightly reduced reliance on debt we would expect a gradual decline in pay-out ratios as corporate earnings increased and an increase in the volume of new equity issues 28/.

The effects of adopting our proposals on the saving and investment of high income, resident-owned corporations without special industry tax concessions can now be briefly summarized:

1. The after-tax income from holding shares in these corporations would increase for resident shareholders, including Canadian life insurance companies and Registered Retirement Income Plans.
2. Share prices would rise.
3. Management would find that the rate of capital formation should be increased, for a lower before-tax rate of return on additional corporate assets would provide shareholders with as high an after-tax rate of return on their shares as they could obtain from other assets.

4. These corporations would rely slightly less heavily on debt to finance this more rapid rate of expansion. Although cash dividends are unlikely to decline absolutely, pay-out ratios probably would decline gradually as corporate profits increased. There would be more reliance on new equity issues than in the past.

EFFECTS ON THE SAVING AND CAPITAL  
FORMATION OF OTHER BUSINESS 29/

Up to this point we have restricted ourselves to the consideration of large, resident-owned corporations receiving no special tax concessions. We have done this to simplify the analysis and to demonstrate the effects of our reforms for the most important type of Canadian corporation. We turn now to an examination of other important kinds of business.

Effects on Large Non-Resident-Owned  
Corporations with No Special Tax  
Concessions

Adoption of our recommendations would have relatively little effect on these corporations.

Abolition of the dual corporate rate would mean that each of these corporations would pay additional taxes of about \$10,000 a year. But this is too small an amount to have a significant impact on cash flow of the larger corporations and would not affect the expected after-tax return to their shareholders on additional investments. In addition, the proposed corporate base changes would not have an appreciable impact. Generally speaking the foreign parents of Canadian subsidiaries would obtain an increased foreign tax credit equal to the increased Canadian tax.

Non-resident shareholders would not, of course, benefit from integration nor would they be subject to the full taxation of share gains. If these corporations had some resident shareholders, however, they could provide them with all the benefits of integration without penalizing their non-resident shareholders 30/. Canadian resident shareholders and Canadian

institutions would bid up the price of such shares. If the shares were widely held by non-residents there would be a tendency for non-residents to sell their shares to residents, for the after-tax return to the latter would be greater than to the former. This exchange is unlikely to take place quickly, however. Non-residents would seek to obtain the maximum capital gain and would be hesitant to realize the gain as long as share prices continued to rise. They would also wish to postpone the realization of the gain.

The cost of Canadian equity capital would be reduced to these corporations as it would be to resident-owned corporations; the cost of other kinds of capital would be unchanged. Assuming that maintenance of control was not a problem, and that the parent corporation did not have excess funds, these predominantly foreign-owned corporations could find it attractive to offer shares in the Canadian market.

Canadian corporations wholly owned by non-resident corporations are much less likely to offer shares in the Canadian market than those that are only partially so owned, but our proposals would certainly give them an incentive to do so.

Because the increase in the Canadian taxes on these corporations would be relatively small, and because these increases could largely be offset by reductions in the taxes payable in other jurisdictions, we expect that these corporations would reduce their pay-out ratios by the small amount necessary to maintain their Canadian retained earnings. The rate of capital expenditures by these corporations is unlikely to change markedly as a result of our proposals. If it changed at all it would increase in response to the lower cost of equity capital in Canada.

#### Effects on Mining and Petroleum Corporations

Withdrawal of percentage depletion and the three-year exemption for new mines would substantially increase the taxes paid by a few of the



largest corporations in the extractive industries. We estimate that in 1964 the taxes paid by fifteen of the largest Canadian mining and petroleum companies would have been approximately doubled under our proposals had their capital cost allowances not been changed in response to the change in the tax system. The actual tax impact is difficult to forecast because under our proposals these companies probably would have increased their write-offs. Over 80 per cent of the change in taxes on all mining and petroleum companies resulting from our proposals would have been borne by these fifteen companies.

The total capital expenditures 31/ made by these fifteen companies, as reported on their 1964 tax returns, were approximately \$220 million. The tax reduction that these companies enjoyed because of percentage depletion and the three-year exemption of the income from new mines, financed in effect, more than half of their capital expenditures in that year. For the mining companies alone the tax reductions provided by these two incentives substantially exceeded the capital expenditures they undertook in that year. Admittedly a comparison of the tax saving and capital expenditure in a single year may not provide the best measure of the value of an incentive, but nevertheless it suggests that the present incentives are inefficient.

Estimates of the effects of our recommendations upon the cash flows of the fifteen firms are provided in Table 37-8. The estimates reflect the effects of eliminating depletion allowances and the three-year exemption; no account has been taken of offsetting recommendations for the full write-off of costs not now permitted and for the more rapid amortization of capital costs. In addition, the favourable effect of our other proposals for the determination of business income generally have been ignored. Despite this bias towards overstatement of the tax increases the estimates show that no reduction in dividends or capital expenditures on the part of these corporations would have been necessary; the corporations would still

TABLE 37-8

EFFECT OF OUR PROPOSALS ON TAXES AND CASH FLOWS FOR  
15 LARGE MINING AND OIL COMPANIES IN 1964  
(millions of dollars)

Taxable income		260
Current tax		<u>128</u>
After-tax earnings as reported on tax returns		132
Dividends received		121
Non-cash charges deducted in computing taxable income		
Depletion	119	
Three-year exemption for new mines	127	
Depreciation and write-off of development	<u>363</u>	<u>609</u>
Cash flow before capital expenditures and dividends paid		862
Dividends paid	263	
Capital expenditures	<u>219</u>	<u>482</u>
Net cash flow under the current tax system		380
Estimated change in taxes resulting from our proposals		<u>124</u>
Net cash flow under our proposals		<u>256</u>

Note: Included are 15 of the largest mining and petroleum corporations and most of their active wholly owned subsidiaries. In computing the effect of our proposals upon taxes paid by these companies, no change in capital cost allowances has been assumed. In addition, no account has been taken of the full write-off of costs permitted under our proposals. The estimated increase in taxes shown in this table consequently overstates the impact of our recommendations. As non-taxable income (other than dividend income) is not included, there might be a small understatement of the actual cash flow of these companies. For the purpose of this table, borrowings and debt repayment are not taken into consideration in determining cash flow. It is estimated that the net debt repayment in 1964 by these companies was approximately \$50 million.

Source: Data supplied to this Commission by some of the companies and data, unidentified as to company, supplied by the Department of National Revenue.

have generated more than \$250 million in cash flow over and above what was paid out in dividends and capital expenditures. Only to the extent that the reduced cash flow would have forced these companies to reduce the funds they made available to other mining and petroleum companies to finance their capital expenditures could the tax increases we propose have forced a reduction in dividends or capital expenditures for mining and petroleum. Because it is unlikely that the fifteen companies put more than \$250 million into other companies in the extractive industries, or that these other companies could not have financed their expenditures in any other way, it seems clear that the tax increases would not force a material cutback in capital expenditures in these industries.

The net effects of our proposals on the rate of return on investments made by Canadian mining and petroleum companies would depend on whether such companies had income in excess of their exploration and development costs. The rate of return to the corporation, measured in terms of corporate cash flows, would gradually decline for the larger petroleum and mining companies who have had income against which to charge these costs. However, the non-integrated mining companies would not be greatly affected and the non-integrated petroleum companies would be in an improved position. As shown in Chapter 23, we estimate that over the long run the average after-tax cash flow rate of return to mining and petroleum companies, excluding the effects on shareholders, would be changed as follows:

	<u>Petroleum</u> (per cent)	<u>Mining</u> (per cent)
Companies with operating income to offset all exploration and development costs	-23	-11
Companies without operating income other than from the particular mine or well	8	-2

The resident shareholders of Canadian corporations in the extractive industries would benefit from the integration of personal and corporation



income taxes and would benefit or have their position worsened by the inclusion in income of property gains and losses. For the resident-owned companies without operating income other than from the particular mine or well there could be small tax increases at the corporate level but there would generally be offsetting tax rebates at the shareholder level. These corporations would be in about the same position as corporations in other industries with resident shareholders. These companies would presumably seek to increase their rate of capital expenditures for the reasons we have discussed. Without any relieving provisions new mining and petroleum companies would probably find the cost of equity capital higher, for the full taxation of share gains would make speculative shares less attractive. This unfavourable impact would be offset, in whole or in part, by the recommended immediate write-down by shareholders of investments in exploration and development.

For resident-owned mining and petroleum companies with operating income in excess of exploration and development costs, the higher taxes at the corporate level would be offset in whole or in part by reduced taxes at the shareholder level. Although the integration of personal and corporation income taxes would more than offset the removal of depletion for low and middle income shareholders, it would not eliminate the impact on upper income shareholders. In addition, the taxation of property gains would affect all shareholders. Thus, in general, the relative position of these companies would deteriorate. This does not mean that exploration and development would cease, for most projects would still be profitable. It does mean, however, that the rate of capital expenditures by these companies would be likely to decline.

Most adversely affected would be the few non-resident-controlled mining and petroleum companies that have operating income substantially in excess of their exploration and development costs. Some of these corporations

would be able to offset, at least to some extent, the increase in Canadian tax against their tax liabilities in other jurisdictions.

In the above discussion of the fifteen large mining and petroleum companies it was pointed out that adoption of our proposals could have doubled their tax liabilities in 1964. As we have stated, the actual amount of the increase in tax that might have resulted is difficult to estimate because these companies could have offset most of the effect of the withdrawal of the concessions by claiming increased write-offs and capital cost allowances. In particular, those mining companies claiming exemptions from tax during the first three years of a new mine could continue to show no taxable income from the operation of the new mine by writing off the development costs. Eventually, after all the costs of getting into production had been written off, the income from the new mine would become taxable; adoption of our proposal would mean that tax payments would begin at least three years earlier. Thus, under our proposals, the income from new mines would continue to be free from tax for a number of years (about ten years if our proposals had applied in the case of the major iron ore developments of recent years) but for fewer years than is possible under the present provisions. Because no tax would be payable until the full costs of development had been written off we do not believe that the removal of the three-year tax free period would seriously restrict the continued development of Canada's mineral resources. No doubt those investors who base their decisions only on the expected after-tax rate of return from the particular project would find that those projects that were barely acceptable before would no longer be worth pursuing as a result of the reduced tax deferment. However, most projects that would have been attractive under the present system would continue to be attractive under the proposed system. Given the methods used by many companies to estimate expected rates of return on projects, the tax changes we propose would not have a material effect on the result. The overriding importance of non-tax considerations to some investors would also be a mitigating factor.

We want to emphasize that the major unfavourable impact of our proposals is on the large mining and petroleum companies and that many of the small and medium-sized corporations in these industries could benefit from our proposals. Loss of the potential tax saving that would result at such time as a new mine came into production, or when the company became taxable and could claim depletion, would affect long-run anticipated earnings, but the special shareholder write-off for exploration expenses would assist the smaller companies with current financing.

The reduction in the capital expenditures of a few large corporations in the extractive industries is not to be deplored. Some of the projects undertaken by these corporations have, we are convinced, lower expected before-tax rates of return than projects undertaken by many other corporations in Canada. If the allocation of capital is to be improved so that future productivity and output are increased, the capital expenditures of corporations with low expected before-tax rates of return must be reduced. This provides the means whereby the capital expenditures of corporations with higher expected before-tax rates of return can be increased without increasing our reliance on foreign saving or reducing current consumption.

We would expect that the large integrated corporations in the extractive industries would not change their pay-out ratios appreciably as a result of the tax changes. Their retentions would therefore decline by about one half of the estimated tax increase of \$150 million. It would not be unreasonable to suppose that their capital expenditures would decline by about the same amount.

#### Effect on Small Corporations

In 1964 there were about 76,000 corporations reporting taxable income of less than \$35,000 and about 10,000 reporting taxable income of more than \$35,000. Removal of the dual rate of corporation income tax would increase the taxes paid by each of the higher profit companies by \$10,150. The corporations with lower profits would have tax increases of up to this amount.



With few exceptions the negative effects of the abolition of the dual rate of corporation income tax would be offset by other changes.

For closely held corporations owned by residents the integration of personal and corporation income taxes would mean that the income from these corporations would be taxed at the marginal personal rates of their shareholders. Because most of these corporations could be treated as partnerships for tax purposes at the option of the shareholders, if the shareholders had marginal personal rates no greater than the average rates paid by the corporation under the present system, there need not be a reduced cash flow at the corporate level. Even if the partnership option was not exercised, in closely held corporations it would be a simple matter for the owners to return to the corporation the tax refunds received against their personal income tax.

Where the resident shareholders of these closely held corporations had marginal personal rates of tax in excess of the average rate now paid at the corporate level, the abolition of the dual rate would reduce cash flow and also reduce the expected after-tax return to the shareholders from additional capital expenditures.

However, the accelerated write-off of capital costs to resident-owned, new and small businesses would offset, to a large extent, the negative effects of the abolition of the dual corporate rate on the corporations with high income resident shareholders. This would be particularly important for small corporations with good growth prospects—the only corporations that should be assisted. Low income corporations with low income resident shareholders would receive a major tax advantage through the implementation of this proposal.

Most low income corporations controlled by non-residents would not be affected one way or the other by the abolition of the dual corporate rate because in most cases shareholders could obtain full credit for the increased Canadian tax against their domestic tax liabilities.

The more liberal treatment of business and capital losses that we propose would reduce the risk to potential investors in new and small enterprises. This would reduce the cost of equity capital to them and encourage a more rapid rate of capital expenditures.

The dual corporation tax rate is an extremely inefficient incentive to small businesses. Replacing this incentive with those we propose would raise more revenue but would not have a deleterious effect on the willingness or ability to expand of the vast majority of new and small businesses.

For rapidly expanding new and small businesses the internally generated funds available for reinvestment would not be reduced by our proposals, and for some corporations such funds would be increased because of the accelerated capital cost allowance provisions. External funds would also be cheaper, for adoption of our integration proposal and the more liberal treatment of losses would make the equities of these corporations more attractive. While the techniques adopted would differ from corporation to corporation, we envisage that the pay-out ratios of these companies would, in effect, decline so as to more than compensate for any increase in tax once the permitted capital cost allowances had been used up.

#### Unincorporated Businesses Generally

Basically we have recommended no change in the tax treatment of unincorporated businesses. The recommended changes in the measurement of business income would apply to all businesses in the same way. The accelerated capital cost allowances for new and small businesses would apply to all businesses regardless of the form of organization as would the less stringent treatment of business losses. Our integration proposal would, in effect, put incorporated businesses on the same tax footing as unincorporated businesses.

Although not of major significance, probably the most important effect of our proposals would be the more stringent treatment of the deduction of expenses that conferred a personal benefit to the proprietor or partner. Where the partner or proprietor has been enjoying substantial tax free benefits in the past the adoption of our proposals could result in higher taxes on the income from this source despite lower tax rates.

We do not expect that the rate of total capital expenditures by unincorporated businesses would be much affected one way or the other by the adoption of our proposals. The incentive to some businesses provided by the postponement of tax as a result of the accelerated capital cost allowance provisions for rapidly expanding small businesses would compensate for the reduced cash flow to some other businesses resulting from the higher average tax rates that would be imposed on their owners.

#### Real Estate

We propose neither to tax imputed rent nor to include in the tax base realized capital gains up to \$25,000 on owner-occupied homes realized in a lifetime. Home ownership would therefore continue to bestow a substantial tax advantage relative to home rentals. With this exception, investments in real estate would become less attractive than at present because such a large part of the total return has arisen from capital gains that we recommend be taxed in full. The payment of this additional tax frequently would be deferred, but there is no doubt that the prospect of higher future taxes would make this kind of investment less attractive.

Because of the reduction in the after-tax rate of return we would expect that real estate prices would decline as a result of the implementation of the system we recommend. This decline would be accentuated by the adoption of our proposal that all those holding real property in Canada would be deemed to be residents for tax purposes. The floor under real estate prices that otherwise would be created by the demand for Canadian real estate by non-residents would be lowered by this provision. Construction activity would be reduced for a period until rents rose sufficiently in response to a growing demand to restore the relative attractiveness of real estate investments. However, future land prices would be lower than they otherwise would be as a result of taxing the gains from rising land prices. The government probably would have to take action to offset any reduction in apartment construction during the transitional period.



ESTIMATES OF CHANGES IN  
BUSINESS SAVING 32/

As the foregoing discussion testifies, analyzing the effects of the adoption of our proposals on business saving and investment is complicated by the multitude of special cases and by the interrelationship between corporation and personal income tax changes for resident corporations and resident shareholders and by the implications for non-resident shareholders of Canadian corporation income tax changes.

It is important that the reader obtain an overall view of the diverse implications of the recommended changes for the rates of saving and investment. For this purpose it is helpful to summarize the major conclusions we have reached:

1. With rare exceptions, the changes in corporation income taxes would not result in equivalent changes in retained earnings. Where there would be reductions in taxes at the shareholder level and only small increases at the corporate level, the corporation could, and we believe would, reduce the proportion of after-tax corporate income distributed. For resident-owned corporations not now enjoying special industry concessions we think that the reduced rate of increase of cash dividends would more than compensate for the relatively small increase in taxes at the corporate level. For non-resident-owned corporations of this type we think the reduction in cash dividends would at least offset the corporation income tax increase.
2. For corporations with special industry tax concessions we would expect no change in the pay-out ratio. Therefore there would be a reduction in retained earnings approximately equal to one half the increase in their corporation income tax.

3. The corporations that would have unchanged or increased retained earnings account for a much larger proportion of total capital formation than do corporations that would have reduced retentions.
4. The corporations with unchanged or increased retentions would also obtain more funds from the capital market to finance their increased capital expenditures.
5. Generally speaking, the tax changes at the shareholder level and the changes in cash dividends would be complementary. The net changes in shareholder cash flow would be much less extreme than the personal income tax changes alone would suggest.
6. Only non-resident shareholders of corporations that would lose industry tax concessions would experience significant reductions in net cash flow. Foreign portfolio investors in these corporations would be more adversely affected than direct investors, for some of the latter would have their increased Canadian corporation income tax at least partially offset by increased foreign tax credits.

To give the reader an indication of the orders of magnitude involved we have calculated what the change in business saving would be if the estimated pay-out ratios that now apply remained unchanged after the proposed tax reforms were put into effect. As can be seen from the data given in column 5 of Table 37-9, our estimates suggest that under this assumption business saving would decline by about \$225 million.

We believe that with the exception of the group of corporations in the extractive industries it is much more likely that, over time,

TABLE 37-9  
CHANGES IN CORPORATION CASH FLOWS, CASH DIVIDENDS AND RELIANCE ON EXTERNAL FUNDS  
THAT COULD BE EXPECTED UNDER SPECIFIC ASSUMPTIONS <sup>a/</sup>  
(millions of dollars)

	Total Tax Declared in 1964 <sup>b/</sup> \$	Proposed Change in Tax <sup>b/</sup> \$	Cash Pay-out Ratios		Change in Retained Earnings			Decrease in Cash Dividends			Decrease in Cash Dividends		
			Estimated Under the Current System <sup>c/</sup> %	Assumed Under the Proposed System <sup>c/</sup> %	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$	If No Change In Pay- Out Ratios As Assumed \$
Industries without major special concessions													
Agriculture, forestry and fishing	12	7	50	40	-3	-2	4	5	3	5	4	4	4
Manufacturing	905	82	50	40	-41	57	41	139	20	139	20	69	69
Construction	37	16	40	30	-10	-4	6	12	4	12	4	7	7
Transportation, storage and other utilities	239	12	65	45	-4	46	8	58	5	58	5	39	39
Wholesale and retail trade	237	77	35	25	-50	-16	27	61	7	61	7	16	16
Finance, insurance and real estate	257	92	60	45	-37	15	55	107	31	107	31	61	61
(excluding life insurance)	46	20	50	40	-10	-3	10	17	7	17	7	12	12
Services													
Total	1,733	206											
Industries with major special concessions <sup>d/</sup>													
Mining and quarrying	117	133	55	55	-60	-73	73	61	14	61	14	12	12
Oil and natural gas	47	19	50	50	-10	-10	9	9	2	9	2	2	2
Total	1,917	458			1,225	10	232	469	93	469	93	222	222

Notes: <sup>a/</sup> Classifications by industries are the same as in Table 37-2 except that life insurance has been excluded from this table. The same notes apply. Columns may not add to totals due to rounding.

<sup>b/</sup> From Table 37-2.

<sup>c/</sup> It is not possible to obtain reliable pay-out ratios from the taxation statistics. We therefore used data published by the Financial Post for 254 Canadian corporations (page 33 of the issue dated May 14, 1966) and information supplied to us by the Department of National Revenue for 200 large private corporations in order to estimate the pay-out ratios. Although these large corporations accounted for over 60 per cent of the profits reported by Canadian corporations, their pay-out ratios are not necessarily representative of all the corporations in each industry as the ratios of the smaller corporations could well be different, and in fact would appear to be substantially less. We therefore reduced the ratios of the large corporations in order to arrive at our estimate of the current ratios. In those industries where insufficient data were available and which form a small proportion of the total, a pay-out ratio of 50 per cent was assumed.

<sup>d/</sup> We assumed that the cash dividends to residents decreased in the same proportion as the cash dividends to non-residents. In fact, we would expect that the pay-out ratios of corporations controlled by non-residents would be relatively inflexible while the ratios for resident-controlled-corporations would be more likely to decline.

<sup>e/</sup> Life insurance is considered as part of personal saving later in the chapter.



pay-out ratios would decline. We do not mean by this statement that we believe cash dividend payments would be reduced but rather that they would not be increased to the same extent as would otherwise be the case. Our estimates of the pay-out ratios that are more likely to prevail under the proposed tax system are given in column 4 of Table 37-9. The changes in retained earnings that would result if the pay-out ratios changed as we have estimated are given in column 6. These data show that, despite the large increase in corporation income tax, with these reduced pay-out ratios retained earnings would rise by about \$10 million. In effect business saving would be unchanged.

The estimated changes in pay-out ratios reflect our belief that for most Canadian-owned corporations not in the extractive industries the adoption of integration would lead to increased retentions. These corporations would find that it was in the interest of their shareholders that they expand their facilities more rapidly; the increased cash flow at the shareholder level because of the tax refunds would mean that corporations could substantially increase their retentions—the least expensive source of capital—without adversely affecting the cash flow of most resident shareholders.

The changes in pay-out ratios for corporations in the extractive industries are less certain. Because the larger companies may in the long run reduce their rates of capital expenditures, some reductions in retained earnings probably would occur. In particular, large mining and petroleum corporations with many non-resident shareholders would be under pressure to maintain their cash dividends. If cash dividends were maintained, their pay-out ratios would be increased in response to the removal of some of the concessions they now enjoy. On the

other hand, smaller companies would experience relatively small tax increases (or none at all) and, to the extent that their shares were held by residents or by foreign direct investors who would obtain credit for higher Canadian taxes, they could reduce their cash dividends without adversely affecting the cash positions of their shareholders.

Lacking more precise information we have assumed that as a group the pay-out ratios of the corporations in the extractive industries would remain unchanged. We are well aware, however, that there would be great diversities among these companies.

Our expectation that there would be no significant change in business saving does not mean, of course, that the rate of capital expenditures by business would necessarily be unchanged. As we have emphasized repeatedly, the proposed tax changes at the shareholder level would greatly increase the attractiveness of Canadian equities to Canadian resident individuals and institutions. Businesses could finance a more rapid rate of expansion by selling more shares at higher prices and by borrowing more although, as we have said, we would expect that the relative reliance on debt would be reduced.

Would business seek to expand its facilities more rapidly? To what extent would additional funds be available if business wished to do so? What fiscal and monetary policies could the government adopt if the desire to invest increased more than the desire to save? These are the crucial questions.

Whether or not there would be funds available to finance a more rapid rate of capital formation depends in part on the effects that our proposals would have on the rate of personal saving. To a discussion of that subject we now turn.

## EFFECTS ON PERSONAL SAVING AND INVESTMENT

The following recommendations could have an appreciable effect upon personal saving:

1. A reduction in sales and excise taxes of \$125 million.
2. Abolition of gift and estate taxes that now raise about \$143 million and the full taxation of the beneficiary on gifts received.
3. A major increase in the progressiveness of the personal income tax so that the average tax unit having high income under the comprehensive tax base would pay substantially more tax, and conversely for low income tax units.
4. A much higher after-tax rate of return on retirement savings, up to a generous limit.
5. Extensive changes in the taxes on corporate source income that would probably result in changes in cash dividends.

The purpose of this part of the chapter is to evaluate the probable net impact of these changes on the level and form of personal saving.

#### The Determinants of Personal Saving

There is no universally accepted explanation of the aggregate saving behaviour of individuals and families. Consequently there can be no universally accepted assessment of the effects on personal saving that the adoption of our proposals would have. We must, therefore, set forth the underlying assumptions on which we have based our analysis.

As we have stated elsewhere in this Report, we assume that for most purposes the family is the basic decision-making unit. We believe that this assumption holds with particular force for decisions respecting saving.



In our view most such decisions are made jointly by husband and wife and take into account the needs of their minor, unmarried children. In analyzing the effects of tax changes on personal saving we will consider primarily typical families.

We believe that typical families, that is to say, families that see themselves as "average" in terms of expected lifetime income, wish to spend substantially all family income during the life of the family and do not expect to make or receive significant gifts or bequests. For this kind of family the major purpose of saving is to achieve a relatively stable standard of living over the life of the family despite a life cycle of income that is expected to be low in the years immediately following marriage, to reach a peak just before retirement, and then to fall off sharply.

How family saving is adjusted to achieve this smoothing of consumption expenditures over the life of the family can be briefly explained.

Immediately following marriage the couple borrows against its few marketable assets and its prospective earnings in order to be able to buy the consumer durables necessary in setting up a home. If the lenders would accept the risk, the liabilities of the family would exceed the value of its marketable assets, that is, it would be technically bankrupt. However, if human capital (the present value of expected employment income) is taken into account, the net worth of the family is both positive and substantial even in the earliest years of marriage.

In the decades immediately following marriage the family slowly increases its marketable assets and pension rights and rapidly reduces its liabilities. As the family approaches middle age the value of the family's human capital reaches a peak; although current and expected annual earnings are higher than past annual earnings there are fewer and fewer working years ahead. As a result of these two changes the net worth, including human capital, of the family gradually rises.

After reaching middle age the family rapidly accumulates marketable assets and pension rights, for current income is high and the family has few liabilities. But the net worth of the family, as we define it, may decline slightly as retirement approaches because the present value of future earnings may decline more rapidly than the accumulation of marketable assets increases.

Following retirement the net worth of the family declines dramatically as marketable assets and pension benefits are drawn down to support a level of current consumption much above current income.

Until the family is very close to retirement, consumption expenditures are roughly proportionate to the net worth of the family, although this may not be achieved in the early years because the necessary funds cannot be borrowed. After retirement, consumption expenditures are a rapidly rising proportion of a rapidly diminishing net worth.

When families gear their current consumption to their current net worth, including human assets, rather than to current income, they go through three distinct saving phases. In the first phase consumption expenditures exceed current income. This dissaving, as we will term it, is financed by borrowing against marketable assets and future income. In the second phase the family earns more than it spends on consumption, and first repays the funds borrowed in earlier years and then rapidly accumulates marketable assets. This is the only phase in the life of the family when the family saves, that is, when disposable income exceeds consumption expenditures. In the final, post-retirement phase, consumption expenditures greatly exceed current income as the family draws upon its capital. The family dissaves.

The significance of the tax changes we recommend for the level of personal saving can now be considered in the light of this brief analysis of the determinants of personal saving for typical families.

## The Effects of Tax Changes on the Rate of Personal Saving

Raising or lowering lifetime disposable income would have little if any effect on the rate of saving by typical families. They eventually consume all of their disposable income. If disposable income was less as a result of higher taxes, consumption would be correspondingly less. Personal saving at any point in the life cycle would be reduced in the same proportion as disposable income over the life cycle was reduced. Because we do not propose significant changes in the level of taxes borne by most middle income families on a lifetime basis, no change in personal saving or consumption would be produced on this account 33/.

Leaving aside the proposed changes in the tax treatment of Registered Retirement Income Plans, adoption of the base and rate changes we recommend would mean that disposable income would be relatively lower for most middle-aged and elderly families and relatively higher for most young families 34/. Consequently net worth would be increased in the early life of the family and reduced in the later life of the family. If, as we believe, families try to achieve current consumption expenditures that are approximately a constant proportion of current net worth, as we have defined net worth, consumption would be raised in the family's early years and reduced in its later years. This would probably serve to smooth consumption expenditures over the life cycle.

For young families consumption expenditures would rise by at least the full amount of the tax reduction and possibly by more than the tax reduction if a higher disposable income increased the family's ability to borrow. For middle-aged families and retired families, the tax increase would have to be financed largely by reduced consumption. Middle-aged families would have to repay the funds borrowed when they were young and, if they wished to achieve the same standard of living on retirement, would probably have to save a higher proportion of income in their best years.



Given no change in the rate of saving (current income less current consumption) by the typical family, increasing the after-tax rate of return on Registered Retirement Income Plans as we propose would increase the net worth of the family as it aged, relative to what would occur in the absence of such a concession. To put the matter the other way, families could achieve a given standard of living after retirement with less saving in middle age.

If personal savings were determined solely in terms of the factors specified above, and if this were the only change recommended, a reduction in personal saving would probably result from the proposed treatment of retirement savings. We doubt that this reduction would occur, however. Largely because of the composition of the assets of retired people, the tax system we propose is likely to increase rather than reduce the taxes borne by retired couples other than those living on pensions and annuities. For one thing, retired couples "living on capital" would realize property gains on their assets before death. This would more than offset the positive effects of integration of the personal and corporation income taxes on this age group. The higher rate of return on Registered Retirement Income Plans probably would do little more than offset the higher taxes that retired people who have deferred property gains would have to pay on the realization of the property gains accrued in the years preceding retirement.

Another factor must be considered. The proposed tax treatment of Registered Retirement Income Plans would make this an even more attractive form of saving. Consequently we would expect that workers generally would press their employers for increased pension contributions at the expense of increased wages. If this occurred, young workers would be forced to save more than they otherwise would. They would accumulate a non-marketable asset against which they could not borrow. By the time they reached middle age and could, if they wished, offset their compulsory pension savings by reduced savings in other forms, they might find that the prospect of a high standard of living after retirement would induce them to save more rather than less when the age of retirement was rapidly approaching.

After considering all of these offsetting effects of our proposed tax changes on personal saving we have come to the conclusion that in the long run adoption of the system we propose would have virtually no effect on the rate of personal saving by typical families. For these families tax reductions at the bottom of the income scale would be reflected entirely in increased consumption; tax increases for those at the "top" of the middle income scale would result in a reduction in consumption equal to about 80 per cent to 90 per cent of the tax increase; the balance of the tax increase on these people would be reflected in reduced personal saving.

At the bottom of the income scale are not only young and old "average" families but also the "permanently poor" who save little if anything. To those who have had nothing and expect nothing only the present is of consequence. A reduction in the taxes paid by these families probably would be used entirely to increase current consumption. More generous retirement savings provisions would be unlikely to have any impact on these families, for those who permanently have the lowest incomes usually are not employed in jobs that have any pension provisions.

At the very top of the income scale are the wealthiest families who save a substantial proportion of their incomes throughout their lives. For families in this group the widening of the tax base under the proposed system would mean that most of them would pay substantially higher taxes. Most of this increased tax burden would probably be at the expense of saving rather than consumption, because these families are unlikely to be target savers. That is, they are not saving to reach a specific goal but rather are accumulating what they do not wish to spend. The limits we would impose on contributions to Registered Retirement Income Plans would be so restrictive that this tax concession would be of little importance to this group of families. We believe, therefore, that the tax increases for most families at the top of the income scale would result in reductions in personal saving that were virtually equivalent to the tax increases.

## Contractual Saving

Contractual saving is an exceedingly large part of personal saving. Adoption of our proposals would affect these savings in a most complex manner. We are recommending changes that would greatly increase the attractiveness of Registered Retirement Income Plans and reduce the attractiveness of life insurance saving. Let us first consider saving through Registered Retirement Income Plans.

By allowing the trustees of registered plans full credit for the corporation income tax underlying their dividend income, by allowing the postponement of all taxes on both contributions to and the income earned by the plan until the funds were withdrawn, by allowing great flexibility in the kinds of assets that could be held, by allowing withdrawal of funds when current income of the beneficiary declined below a limit, and by allowing lump sum contributions, Registered Retirement Income Plans would be an exceedingly attractive investment. The suggested limits are sufficiently high that for most low and middle income families the desire to save rather than the availability of the concession would determine how much of this kind of saving was done. Only upper income families would be deterred from increasing their Registered Retirement Income Plans by the proposed upper limits. We expect that an even larger part of personal saving would take this form.

In a growing economy the tax postponement on Registered Retirement Income Plan savings would provide a permanent reduction in tax because the assets of such plans would be increasing over time. We estimate that this tax postponement would be equivalent to a tax reduction of at least \$50 million a year. We believe that personal saving would increase by at least the amount of this reduction.

On the other hand, we propose that the business income of life insurance companies should be defined in the same way as that of other companies.



Adoption of this proposal would increase the taxes paid by these companies by about \$75 million. If, as we expect, this tax increase was substantially absorbed by reduced reserves and only partially offset by lower policyholder dividends or higher premiums, personal saving, as defined in the National Accounts, would be reduced by nearly the amount of the tax increase.

While the adoption of this proposal would reduce personal saving, it would increase the amount of these savings that was invested in Canadian equities. At the present time the interest income of life insurance companies is not subject to tax while their dividend income has, in effect, been subject to the underlying corporation income tax. Because our proposals would result in the full taxation of interest income, either to the insurer or the policyholder, this would make investments in shares relatively more attractive.

While the taxation of the business income of life insurance companies would be unlikely to affect policyholders significantly, we also propose that policy dividends be taxed. This would clearly make life insurance less attractive. Some substitution of saving through Registered Retirement Income Plans for life insurance saving would therefore be likely to occur.

Ignoring here the taxation of policy dividends, which are included in the estimates of changes in the personal income tax, we estimate that the net effect of the tax changes on contractual saving would be to reduce personal saving by \$25 million. The \$50 million reduction of taxes on savings made through Registered Retirement Income Plans would be more than offset by the \$75 million increase in the taxes borne by life insurance companies.

#### Estimates of the Changes in the Rate of Personal Saving

We have made rough estimates of the possible impact on personal saving of the following changes:

1. Changes in the level and progressiveness of the personal income tax.

2. The abolition of gift and estate taxes and the taxation to the donee of gifts received.
3. Changes in the level of the sales tax and the sales tax base.
4. Changes in the level of cash dividends as a result of the changes in the taxation of corporate source income.

These estimates are given in Tables 37-10 to 37-12.

There are no reliable estimates available as to the proportion of a change in income that is saved by income class under the present tax system. To derive rough estimates of the possible implications of our proposed tax changes for the volume of personal saving we have had to assume the values of these proportions. We have made assumptions that we think are conservative; they probably overstate the negative effects on personal saving of the adoption of our proposals.

As is indicated by the data given in Tables 37-10 and 37-11 it can be seen that we estimate that the recommended personal income tax changes, abolition of gift and estate taxes and the proposed sales tax changes could have reduced personal saving by about \$40 million in 1964, ignoring all transitional provisions.

Earlier in this chapter we discussed the possible impact that the adoption of the proposed tax system would have on business saving. It was pointed out that we expect that a substantial part of the increased taxes borne by corporations would be reflected in reduced cash dividends rather than in reduced corporate retentions. On the assumption that the cash dividends paid to resident shareholders would decline by over \$200 million, we provide in Table 37-12 an estimate of the extent to which this would reduce the level of personal saving by residents 35/. Given the allocation of dividends among taxpayers in different income classes and the assumed proportion of a change in income that would be saved by each class, we estimate that such a reduction in cash dividends would reduce personal saving by about \$70 million.

TABLE 37-10

ESTIMATED CHANGES IN PERSONAL SAVING AS A RESULT OF THE PROPOSED CHANGES  
IN THE PERSONAL INCOME TAX AND IN THE GIFT AND ESTATE TAXES

<u>Compre- hensive Income Class</u>	<u>Personal Income Tax</u> (millions of dollars)	<u>Gift and Estate Tax</u> (millions of dollars)	<u>Total</u> (millions of dollars)	<u>Assumed Proportion of Tax Reduction Saved and of Tax Increase Financed Through Reduced Saving</u> Per cent	<u>Estimated Change in Personal Saving</u> (millions of dollars)
Less than - \$1,000	-4.3	-0.7	-5.0	0	0
1,000 - 1,999	-16.7	-2.0	-18.7	0	0
2,000 - 2,999	-17.1	-4.8	-21.9	0	0
3,000 - 3,999	-22.3	-5.7	-28.0	0	0
4,000 - 4,999	-22.9	-6.9	-29.8	5	1.5
5,000 - 5,999	-13.0	-6.6	-19.6	5	1.0
6,000 - 7,999	-12.3	-10.2	-22.5	5	1.1
8,000 - 9,999	-1.8	-8.0	-9.8	5	.5
10,000 - 11,999	5.4	-7.9	-2.5	10	.3
12,000 - 14,999	9.8	-12.4	-2.6	10	.3
15,000 - 19,999	7.4	-13.6	-6.2	15	.9
20,000 - 24,999	0.4	-8.0	-7.6	15	1.1
25,000 - 34,999	-0.5	-11.1	-11.6	20	2.2
35,000 - 49,999	7.6	-11.9	-4.3	20	.9
50,000 - 74,999	14.2	-9.7	4.5	20	-.9
75,000 - 99,999	13.8	-5.7	8.1	50	-4.0
100,000 - 149,999	20.7	-6.2	14.5	50	-7.2
150,000 - 199,999	12.7	-3.2	9.5	75	-7.1
200,000 - 299,999	14.2	-3.3	10.9	100	-10.9
Over - 300,000	21.6	-5.0	16.6	100	-16.6
Unallocated	-24.9	—	-24.9	—	—
Total	<u>-8.0</u>	<u>-143.0</u>	<u>-151.0</u>		<u>-36.9</u>

Source: Tables C-5 and C-6, Appendix C to this Volume



TABLE 37-11

ESTIMATED CHANGES IN PERSONAL SAVING AS A RESULT OF  
THE PROPOSED CHANGES IN THE SALES TAX FOR 1961  
(millions of dollars)

Comprehensive Income	Sales Tax Payable		Change	Assumed Proportion of a Tax Reduction Saved and of a Tax Increase Financed Through Reduced Saving	Estimated Change in Personal Saving
	Under the Current System	Under the Proposed System			
Less than \$2,000	91	89	-2	0	0
2,000 - 2,999	91	83	-8	0	0
3,000 - 3,999	148	130	-18	0	0
4,000 - 4,999	194	168	-26	5	1.3
5,000 - 6,999	388	338	-50	5	2.5
7,000 - 9,999	303	262	-41	5	2.0
10,000 -	190	225	35	20	-7.0
Total	<u>1,405</u>	<u>1,295</u>	<u>-110</u>		<u>-2.2</u>

144

Source: Table E-1 in Appendix E to this Volume.

TABLE 37-12

ESTIMATED CHANGE IN PERSONAL SAVING AS A RESULT OF THE ESTIMATED  
REDUCTION IN CASH DIVIDENDS RESULTING FROM THE **TAX**  
CHANGES AT THE PERSONAL AND CORPORATE LEVELS

<u>Comprehensive Income</u>	<u>Estimated Reduction in Cash Dividends</u>	<u>Assumed Proportion of a Reduction in Dividends Reflected in Reduced Saving</u>	<u>Estimated Change in Personal Saving</u>
	(millions of dollars)	Per cent	(millions of dollars)
Less than \$1,000	0.7	0	0
1,000 - 1,999	1.3	0	0
2,000 - 2,999	3.3	0	0
3,000 - 3,999	4.2	0	0
4,000 - 4,999	6.4	5	- .3
5,000 - 5,999	5.1	5	- .3
6,000 - 7,999	10.9	5	- .5
8,000 - 9,999	10.2	5	- .5
10,000 - 11,999	8.0	10	- .8
12,000 - 14,999	11.3	10	-1.1
15,000 - 19,999	16.2	15	-2.4
20,000 - 24,999	11.8	15	-1.8
25,000 - 34,999	18.6	20	-3.7
35,000 - 49,999	22.9	20	-4.6
50,000 - 74,999	23.1	20	-4.6
75,000 - 99,999	10.9	50	-5.4
100,000 - 149,999	15.3	50	-7.6
150,000 - 199,999	8.9	75	-6.7
200,000 - 299,999	10.0	100	-10.0
Over 300,000	<u>20.9</u>	100	<u>-20.9</u>
Total	<u>222.0</u>		<u>71.2</u>

Note: Columns may not add to totals due to rounding.

Source: The estimate of the total change in cash dividends is from Table 37-9. The allocation by income class is derived from the allocation of dividends by income class shown in Appendix B to J. Bossons, Changes in Direct Taxes on the Components of Income, a study published by the Commission.

By putting all of these estimates together we obtain an estimate of the total change in personal saving that would result from the adoption of the proposed system. This estimate is given in Table 37-13.

TABLE 37-13

ESTIMATE OF THE REDUCTION IN PERSONAL  
SAVING AS A RESULT OF THE ADOPTION OF  
THE PROPOSED SYSTEM

(millions of dollars)

Changes in personal income tax and abolition of gift and estate taxes	40
Changes in sales tax	0
Changes in cash dividends	70
Changes in taxation of contractual saving	<u>25</u>
	<u>135</u>

Note: Amounts have been rounded to avoid giving a spurious impression of accuracy.

Sources: Tables 37-10, 37-11 and 37-12 and the text of this chapter.

Total personal saving in 1965 was about \$3 billion. Given the assumptions we have made, and we believe that they are reasonable assumptions, the reduction in personal saving would therefore be less than 5 per cent.

#### Changes in the Form of Personal Saving

The form of personal saving would be altered more than the volume of personal saving by the adoption of the changes we recommend. When implemented, the tax system we propose would change the after-tax income from different assets differently 36/. The relative prices of assets would change. This would lead to changes in portfolios. It would also bring about an increased supply of the assets with higher prices and a reduced supply of the assets with lower prices. This supply response would, in the long run, tend to



restore relative asset yields 37/. But in the process, and it would be an extremely slow process, more savings would be channelled into the formation of some kinds of physical assets and less into the formation of others. There would be a once-and-for-all change in the composition of the stock of physical assets. This would change labour productivity and thereby the output of the economy.

There can be no doubt that the changes we propose would increase the price of equities relative to the price of fixed interest bearing securities. Consequently the stock of physical assets that are financed through the sale of equities would be increased relative to the stock of physical assets that are financed through the sale of interest-bearing securities. "Safe" investments would be more difficult to finance. Capital expenditures by the smaller, more risky corporations would be more easily financed.

We envisage that adoption, or anticipated adoption, of our recommendations would have the effects on asset prices described briefly below:

1. The Report contains many novel proposals. The market would find it difficult to evaluate their impact quickly or the likelihood that they would be adopted by the government. The market's typical reaction to uncertainty is a reduction in demand and lower security prices; we would consequently expect stock prices initially to fall.
2. On further examination of the proposals and in anticipation of their adoption, we believe that share prices would rise and that the prices of other assets would tend to be depressed.
3. Adoption of our proposals would mean that low income resident shareholders and institutions would find that the much higher after-tax income from Canadian equities would justify paying a substantially higher price for them. The after-tax income from other assets would

be unchanged or reduced. Investors would therefore seek to sell other assets and buy equities. This would tend to depress the price of other assets and raise equity prices. Those shareholders who would obtain no net benefit from integration would wish to hold Canadian equities until the price rise had taken place. Consequently, upper income residents and non-residents would want to hold their Canadian equities until it was expected that the rise in share prices had come to an end. Residents holding equities in non-Canadian companies would, in many cases, sell them, at unchanged prices in most cases, and use the proceeds to bid up the prices of Canadian equities.

4. Unless lower bond prices—higher interest rates—were appropriate for the economy at the time, the Bank of Canada would presumably support bond prices through more rapid increases in the money supply, as discussed below. If this did not occur an increase in the capital inflow could result as non-residents increased their purchases of Canadian bonds at attractive prices. Real property prices would probably decline, but the rising rents that would follow a reduction in construction probably would restore the after-tax rate of return required to attract capital within a relatively short period.
5. The trustees of Registered Retirement Income Plans would obtain full credit for the corporation income tax and would not be taxed on realized property gains. The tax position of life insurance companies would be the same for investment income of all kinds—it would be taxed in full in the hands of the insurer or the policyholder—and therefore the relative attractiveness of shares would be substantially improved. If there were no change in security prices, the before-tax cash flow rate of return 38/ from equities that is now 3 per cent to 4 per cent would rise to 8 per cent to 11 per cent, while the equivalent return from bonds and mortgages would remain at 5 per cent to 8 per cent. We would not

expect these institutions to reduce their holdings of bonds and mortgages at a loss; we would expect them to gradually increase the proportion of equities in their portfolios. Given their extremely large cash inflows, these institutions would absorb a large volume of new equity issues 39/.

6. With higher prices for most Canadian equities, corporations would, as we have indicated, increase their rates of capital expenditure and the proportion of those expenditures financed through new equity issues. This increased flow of new equity issues and relatively reduced reliance on debt would tend to limit the rise in equity prices and would help to support the prices of other assets.
7. Once the increased profitability of Canadian equities to residents was fully capitalized in share prices, non-resident portfolio investors would find that the after-tax rates of return on Canadian equities were lower than they could obtain on other assets. When they anticipated that the rise in Canadian share prices resulting from this capitalization was coming to an end, non-residents would tend to sell their Canadian shares to Canadians and buy other assets. This too would tend to stabilize equity prices at the resultant higher level.
8. Upper income residents, like non-residents, would find that the after-tax rate of return on equities was relatively less attractive at the higher prices and they would probably seek to adjust their portfolios accordingly. Here again this would tend to stabilize equity prices at the higher level.
9. At some point a new equilibrium among asset prices would be established at which the greater flow of new equity issues would be matched by the increased flow of personal savings allocated to the acquisition of this kind of asset. At these prices the marginal investor would



expect that, after making appropriate adjustments for differences in risk, the same after-tax rate of return would be obtained on all financial assets.

This then is what we foresee; an increase in the price of most Canadian equities, little change in bond prices and a decline in the price of other assets. After the prices of assets were stabilized more Canadian equities would be held by low and middle income individual Canadians and savings institutions. Fewer Canadian equities would be held by high income residents and by non-residents. As a result of these higher equity prices, Canadian corporations, other than those in the extractive industries, and some Canadian wholly owned subsidiaries of foreign parents, would at least maintain their retentions and offer more new equities. These equities would be purchased by low and middle income Canadian investors either directly or through life insurance companies or Registered Retirement Income Plans.

#### OVERALL EFFECTS ON THE RATE OF SAVING AND INVESTMENT

The foregoing estimates suggest that had the proposed tax system been in effect in 1964, and had all transitional adjustments been made prior to that date, and had the economy been operating at the same level, personal saving would have been reduced by about \$135 million and business saving would not have been changed. Assuming that government expenditures would have been affected by the adoption of our tax proposals, this reduction in private domestic saving would have been more than offset by an increase in government saving because, as discussed in Chapter 35, under the conditions specified above the proposed tax system would have increased total government revenues by more than \$200 million. Together these estimates indicate that the adoption of our proposals would have increased total domestic saving by \$65 million. Because this amount is so small relative to total domestic saving and is derived from estimates that are subject to such wide ranges of error, for all practical purpose it should be treated as an estimate of no significant change in domestic saving.

Later in the chapter we consider the implications of our recommendations for the balance of payments. We can anticipate that discussion by stating that we foresee no change in Canada's reliance on foreign saving as a result of implementing our proposals.

With virtually no change in domestic saving and no change in our reliance on foreign saving we conclude that the rate of capital formation would also remain unchanged although future output would be increased because the allocation of capital would be improved.

This is the outcome we seek, for, as we explained in Volume 2 and in the introduction to this chapter, we believe that it is our task to design a more efficient tax structure and not a structure that would force Canadians to save and invest more. Policies that could be adopted to increase the rate of saving and investment if this was desired are discussed briefly later in this chapter.

To illustrate the direction and orders of magnitude of the changes in the flows of funds between sectors of the economy that could follow the adoption of the proposed tax system, we have prepared Table 37-14. Because the transactions accounts that were initiated by the Royal Commission on Canada's Economic Prospects have not been carried beyond 1954, we have been unable to make estimates of the magnitudes of the intersectoral flows of funds. Although the data given in this table have expository value only, they show succinctly one of the possible adjustments that could take place.

In this illustration the government's increased saving of \$200 million would permit it to reduce its borrowing by that amount. This, together with the purchases of debt by non-residents, would make it possible for households and contractual savings institutions to sell bonds and buy equities despite reduced savings by these sectors. Some of these equities would flow from non-residents; others would be net new issues by Canadian corporations that would

TABLE 37-14

ILLUSTRATION OF THE POSSIBLE INCREMENTAL EFFECTS OF THE PROPOSED  
TAX REFORMS UPON FLOW OF FUNDS BETWEEN MAJOR SECTORS  
(millions of dollars)

Sector	Gross Savings (- = re- duction)	Uses of Funds (- = Incremental Source of Funds)			
		Corpo- ration Equity	Bonds	Existing Real Assets	Capital Expenditures
Households	-110	140	-200	-50	-
Contractual savings institutions	- 25	75	-100	-	-
Business	-	-140	-	75	65
Government	200	-	200	-	-
Rest of world (foreign investment)	nil (that is, no change in current account deficit)	- 75	100	-25	-
Totals	65	-	-	-	65

Source: The gross savings estimates were provided earlier in this chapter; the other amounts are hypothetical.



make it possible for them to buy existing real assets from Canadian households and increase their capital expenditures slightly.

Underlying all of our estimates has been the assumption that the willingness to save of individuals would not be altered by changes in after-tax rates of return and that the changes in the willingness to save and invest through corporations would be subject to offsetting changes. In short, we have assumed that for the economy as a whole the propensities to save and invest would be unaffected by the implementation of our recommendations.

If these assumptions turn out to be valid it would mean that the adoption of our proposed system would neither stimulate nor depress the economy. Only the allocative effects would be of importance.

It is difficult to appraise the likelihood that this nice balance would prevail. The available evidence supports the view that the willingness to save by individuals is not much influenced by changes in rates of return. Moreover, while it is possible that the willingness to save by upper income individuals would decline as the progressiveness of the system was increased, it is also possible that the more liberal treatment of Registered Retirement Income Plans that we propose would significantly increase the willingness to save by those with lower incomes. If we have made erroneous assumptions with respect to personal saving the errors are unlikely to be in the same direction.

To what extent would large, resident-owned corporations without tax concessions wish to increase their saving and capital expenditures in response to the reduction in the cost of equity capital? To what extent would other corporations wish to reduce their saving and capital expenditures on the withdrawal of their present concessions? These are the crucial and difficult questions. We have estimated that the former would just offset the latter. If we have erred in these assumptions, we believe that we have underestimated the increase in the willingness of the large, resident-owned corporations without concessions to increase their capital expenditures. However, we doubt that

we have underestimated their willingness to increase their retentions. This means that if the adoption of the proposed tax system had a significant impact on the level of economic activity it would have an expansionary impact.

Because it is so difficult to estimate with certainty the impact that the adoption of our proposals would have on aggregate saving and investment it might be argued that it would be too risky to implement our proposals. In assessing these risks it must be constantly borne in mind that these aggregative effects could be offset through the use of fiscal or monetary policies if the level of economic activity did not require stimulus or repression. If the need to maintain external stability presented no problem, the choice of policies used to offset these aggregative demand effects should reflect society's evaluation of the merits of more present consumption relative to more economic growth.

If the tax reforms provided a greater stimulus to investment than to savings, policies to lessen aggregate demand would have to be adopted. The use of restrictive fiscal policy, such as tax increases or a reduced rate of growth or expenditures or both, would permit the realization of the increased propensity to invest, thereby accelerating the rate of economic growth and restricting the level of current consumption. If a restrictive monetary policy were adopted instead, the potential inflationary pressure would be contained by limiting the increase in the propensity to invest to match the increase in available savings. This would permit a somewhat higher level of current consumption at the cost of a somewhat lower rate of economic growth. Even in this case, however, net national savings would be increased by the reforms so that the joint effect of the tax reforms and the offsetting restrictive monetary policy would be to raise savings and investment above the prevailing levels prior to the reforms, thereby enhancing economic growth and reducing current consumption.

If the tax reforms provided a greater stimulus to savings than to investment, offsetting policies to stimulate aggregate demand would be called for. In this case, the adoption of an easy monetary policy to raise the propensity to invest to match the higher propensity to save would favour economic growth at the expense of current consumption; the adoption of an expansionary fiscal policy to limit the increase in savings to match the smaller increase in the propensity to invest would achieve a somewhat smaller increment in the growth rate with a smaller reduction in current consumption. It is therefore clear that, whatever the aggregate demand effects of the tax reforms, unless there were balance-of-payments constraints, they could be effectively offset by using the well-known tools of fiscal and monetary policy 40/.

Because the need to maintain the external stability of the economy can circumscribe fiscal and monetary policies let us now turn to an examination of the effects of the tax reforms upon the balance of payments.

#### EFFECTS OF THE TAX REFORMS UPON THE BALANCE OF PAYMENTS

The tax reforms could impinge on the balance of payments both through their direct effects on the international flows of goods, services, income and capital and through indirect repercussions upon aggregate demand, the division of the gross national product between consumption and investment, and the rate of economic growth.

The net effect of the reforms upon the balance of payments is therefore extremely difficult to determine. Furthermore, the effects during the transitional stages, when existing holdings of assets were being adjusted, might differ from the long-run equilibrium effects upon the flows of income trade and capital.

We will first consider the direct effects of the tax reforms upon the balance of payments. By "direct effects" we mean effects upon trade and capital flows at given levels of aggregate demand and investment and at a given rate of economic growth. Later we shall consider the indirect effects.



## Current Account

We expect that the tax reforms would have little direct effect upon merchandise imports and exports. As was pointed out in Chapter 5, International, the tax system should be neutral with respect to exports, imports and domestic production. We have not found the present system to be discriminatory in this respect; we have been careful to avoid discriminatory features in designing the new system. Perhaps it is worthwhile recapitulating the arguments that underlie this conclusion.

Direct taxes do not have much effect upon exports and imports. Extensive forward shifting of increases in the corporation income tax through higher prices might impair exports and encourage imports, at a given exchange rate, but we find no evidence that extensive forward shifting of this kind has occurred. In any event, the recent devaluation of the Canadian dollar swamped any adverse effects that the relative increase in Canadian corporation income tax might have had.

While the adoption of the proposed reforms would substantially increase corporation income tax collections, for most resident-owned companies other than those in the extractive industries the corporation income tax increases would be more than offset by reductions in taxes at the shareholder level. The overall tax burden on corporate source income would therefore be reduced for most industries.

Because most Canadian corporations would not be subject to increased competition from new firms or new products from abroad we doubt that these tax reductions at the personal level would be quickly passed on to consumers in the form of lower prices. On the other hand, those industries that would be subject to tax increases at the corporate level that were not fully offset by reductions at the personal level would be unlikely to pass the increases on in the form of higher product prices except where the firms had substantial international market power.

The present indirect tax system does not discriminate systematically either for or against imports because both imports of manufactured products and domestic manufactured products bear the same tax rate at about the same stage of fabrication. However, specific instances of discrimination one way or another are inherent in the administratively cumbersome manufacturer's sales tax. The replacement of this tax with a general retail sales tax would provide a system that was non-discriminatory throughout, for all taxable goods and services would bear the same tax rate at the final stage of purchase regardless of where value was added.

We therefore conclude that any substantial effects of the tax reforms upon the merchandise account of the balance of payments would involve only the repercussion of their effects upon demand, investment and the rate of growth.

The non-merchandise current account is another matter. Those portions of this account which represent trade in services, such as tourism, travel, shipping and freight, would likely be unaffected by the reforms because the logic of the previous discussion applies with equal force to these cases. At present, services bear no sales tax, whether imported or domestically produced. In the future most services would bear retail sales tax, but both imported services and domestically produced services would bear the same rate of tax to the ultimate purchaser.

However, the interest and dividend payments portion of the current account probably would be affected. In the long run these flows would be influenced by the same forces that affect the capital account, which is discussed below. In addition, the dividend outflow would be affected more quickly by the reaction of non-resident-controlled Canadian corporations to the various corporation income tax changes.

We estimated above that non-resident-controlled corporations other than those in mining and petroleum would, generally speaking, at least maintain their retentions and capital expenditures in the face of the modest increase in

their corporation income tax burdens. This implies that the dividend outflow would be reduced by the full amount of the tax increase or that an equivalent increase in direct investment would take place. For large non-resident-controlled corporations in the extractive industries, investment probably would be cut back. Such corporations with many non-resident shareholders probably would try to maintain their dividends; many closely held companies, on the other hand, probably would maintain their present pay-out ratios. Some reduction in the dividend outflow seems to be likely.

#### Capital Flows

Unlike the merchandise flows, where the direct effects would clearly be minimal, the tax reforms could substantially affect international capital flows. But the net effect upon the capital account is difficult to assess because the separate effects on the various capital flows are in different directions: some capital inflows probably would be reduced, but some capital outflows probably would be reduced too. We will now consider each of the main components of the long-term capital flows in turn 41/.

To the extent that foreign direct investment is sensitive to tax changes, for example where changes in the Canadian tax are not offset by increased foreign tax credits on marginal projects, direct investment in Canada would, in all likelihood, be reduced, mainly as a result of the reduced incentives to invest in the extractive industries. However, because a large proportion of foreign investment in these industries probably is insensitive to the kinds of tax changes we propose, we do not expect that a major reduction would take place.

We do not expect that foreign direct investment in the non-resource industries would be much affected by our tax reforms. Because the after-tax rate of return at the margin would not change, the attractiveness of these direct investments in Canada would not be affected. Some non-resident-controlled Canadian corporations probably would decide to issue new equities to Canadian residents. But these issues would be as likely to be used to finance additional



capital expenditures as to replace foreign direct investment. In any event, the magnitudes involved would be small.

Adoption of our proposals would not make direct investments abroad absolutely less attractive to most resident shareholders, with the exception of investments in tax haven countries. But integration would mean that their relative attractiveness would be reduced. Although Canadian corporations that carry on an international business are not likely to be affected one way or the other, some reduction in foreign direct investment by Canadians seems probable.

The international trade in securities includes trade in outstanding issues of government bonds, corporate bonds and stocks, as well as net new issues of these items. The composition of these capital flows would almost certainly be affected by the tax reforms.

As we have emphasized earlier, under a system of integration of corporation and personal income tax residents would tend to switch to Canadian equities and to sell off other securities, such as domestic and foreign bonds and foreign equities, thereby putting upward pressure on Canadian equity prices and downward pressure on Canadian bond prices. The prices of the vast majority of foreign securities would not be affected significantly because Canadian holdings of these securities typically account for only a small fraction of the total.

The available evidence suggests that international portfolio capital flows are quite sensitive to small changes in yield differentials between Canadian and United States securities 42/. Consequently the price pressures exerted by the portfolio adjustments of Canadian residents stimulated by integration would lead to offsetting portfolio adjustments by non-residents, thereby lessening the ultimate price adjustments that would occur 43/.

The probable direction of the various adjustments in domestic and foreign portfolios is summarized in Table 37-15 below, together with the effects of these adjustments upon prices and yields.

TABLE 37-15

INTERNATIONAL CAPITAL FLOWS:  
DIRECTION OF EFFECTS UPON ASSET HOLDINGS,  
PRICES AND YIELDS

	<u>Canadian Bonds</u>	<u>Canadian Stocks</u>	<u>Foreign Securities</u>
Holdings of Canadian residents	-	+	-
Holdings of non-residents	+	-	+
Price	-	+	No change
Yield (before tax)	+	-	No change

Three results are possible. These various portfolio adjustments could have a net positive or a negative impact on the balance of payments 44/; the repatriation of Canadian capital currently invested in foreign securities could be matched by an equivalent net reduction in the inflow of foreign portfolio capital.

The outcome would depend upon the sensitivity of the different capital flows to changes in yields and upon the effects of changes in other sources and uses of funds (direct investment flows, retained earnings, and personal savings) that affect the net portfolio capital requirements of the Canadian economy.

However, given the extreme sensitivity of the foreign demand for Canadian bonds to international interest rate differentials, we believe that the positive effects of the reduction in Canadian purchases of foreign securities and the increased demand for Canadian bonds by foreigners, brought about by the increase in interest rates induced by the portfolio adjustments of Canadian residents, would be greater than the negative effects of reduced purchases of Canadian equities by foreigners. Probably the net effect of the various changes in portfolio flows would be an increase in official reserves unless the money supply was expanded more rapidly to hold down the

increase in interest rates and to reduce the purchases of Canadian bonds by foreigners.

One other aspect of these changes in portfolio capital flows should be mentioned. Increased Canadian and reduced foreign net purchases of Canadian equities would lead in the long run to some repatriation of ownership over large segments of Canadian industry. This would be achieved at the cost of reducing Canadian holdings of foreign equities and increasing foreign holdings of Canadian debt.

In summary, it appears probable that the reduced dividend outflow, reduced direct Canadian investment abroad, reduced investment by Canadians in foreign securities, and the increased foreign purchases of Canadian bonds, stimulated by the upward pressure on bond yields brought about by the portfolio adjustments of Canadians, would more than offset the reduction in foreign direct investment in Canada and in foreign purchases of Canadian equities. If this occurred the balance of payments would be "improved" in the sense that official reserves would tend to rise in the absence of offsetting policies. Given Canada's commitment not to increase its foreign exchange reserves, the government might have to support Canadian bond prices through a more rapid increase in the money supply and, if the economy was operating at capacity, offset this expansionary move by a more stringent fiscal policy.

In concluding our discussion of the direct effects of our proposals on the balance of payments it should be pointed out that the changes we recommend for the taxation of mineral extraction would not give rise to any special problems. The tax changes we put forward, if adopted, would not have a significant effect on production from existing facilities. There is no fear of a sharp drop in our mineral exports or an immediate increase in our mineral imports. Although we doubt that future capital expenditures by the extractive industry would be much reduced, any reduction in investment would, of course, result in a decline in future mineral production and presumably mineral exports relative to what otherwise would take place. This is no



cause for alarm, however, for the improved allocation of capital would increase the ability of Canadian industry generally to compete more effectively both in foreign markets and against foreign goods in the Canadian market. A reduction in one kind of export does not mean a deterioration of our trade position.

We do not expect that there would be significantly less foreign direct investment in the Canadian extractive industries or significantly increased direct investment by Canadians in foreign mineral extraction for the reasons we have already given. But should our expectations not be realized it must be borne in mind that a reduced inflow of foreign "extractive industry" capital and an increased outflow of Canadian "extractive industry" capital does not necessarily mean a net reduction in the capital available for Canadian development. The net capital inflow could be maintained by the increased sale of Canadian debt instruments to non-residents to compensate both for the reduced sale of Canadian extractive industry equities to non-residents and the increased purchase of foreign extractive industry equities by residents.

#### Indirect Effects

If the adoption of our proposals increased the propensity to invest this would tend to worsen the current account of the balance of payments in the short run. The high import content 45/ of investment goods means that a change in the composition of demand in favour of investment would lead to an increase in imports. If the increase in the propensity to invest had a net positive effect on aggregate demand, that is, if it was not matched by an increased propensity to save or by a tightening of fiscal policy, there would be an additional increase in imports. Unless matched by an increase in the net capital inflow the deterioration in the current account would lead to a loss of reserves.

In the past, investment booms have been accompanied by a strengthening of the Canadian dollar in the foreign exchange market. But it is not clear that these episodes, which were accompanied by or partially brought about by the buoyant expectations of non-residents regarding future profits that could be obtained from direct investments in Canada, provide any evidence as to the effect on the capital inflow of a change in investment engineered by tax structure revisions. In the unlikely event that the implementation of our proposals brought about an investment boom without an equivalent increase in personal or business saving and without a substantial increase in foreign direct investment, the government would have to be prepared to tighten fiscal and monetary policies quickly to avoid a decline in Canada's exchange reserves. The mix of policies that should be adopted would depend essentially on the extent to which the government wished to increase the proportion of GNP invested. The alternatives are discussed in Volume 2.

It is sometimes argued that a more rapid rate of growth would lead to a gradual but cumulative worsening of the current account of the balance of payments. As was stated in Chapter 4, it is important to distinguish the effects of an increased rate of growth brought about by stimulating aggregate demand from an increase in the rate of growth of potential output that is matched by an increase in aggregate demand.

The stimulation of aggregate demand alone leads to real growth gains only until full employment is reached and is therefore unsustainable in the long run. Furthermore, any closing of the gap between actual and potential output typically stimulates an increase in imports under a fixed exchange rate system. Exports are unlikely to be affected much by the closing of the gap. However, if the stimulation of aggregate demand is pursued after full employment is reached the resulting inflation weakens the competitive position of Canadian exports and stimulates imports.

The tax reforms would increase the rate of growth of potential output by:

1. Gradually achieving an improved allocation of resources.
2. Causing Canadians to shift their investments from foreign to domestic capital expenditures 46/.
3. Reducing barriers to greater effort as a result of lower effective marginal tax rates on employment income.

The tax reforms would therefore permit a sustainable increase in the rate of growth of output and aggregate demand. Such an increased rate of growth would not cause a cumulative worsening of the balance of payments, for the increased supplies of the factors of production and the increase in their productivity would encourage an expansion of exports. Given the elastic foreign demand for Canadian manufactured products and services we would expect the stimulus to the production of exports and to the production of import substitutes to offset completely the expansion of the demand for imports brought about by the increase in aggregate demand that would accompany the increase in the rate of growth in potential output.

#### IMPLICATIONS FOR ECONOMIC OBJECTIVES

Rational economic policy making involves the achievement of the accepted objectives within the limits imposed by a variety of technological and institutional constraints. The existence of the constraints sometimes forces the policymaker to limit the pursuit of one objective in order to better achieve some other objective.

The art of public policy formation therefore involves two logically distinct steps:

1. Ensuring that each objective is pursued in so far as no conflict with other objectives exists. Any set of policy decisions that fails to achieve these "costless" improvements may be said to be inefficient. Hence the first problem is the achievement of policy efficiency.



2. When one objective may be better realized only at the reduced achievement of another objective the policy maker must ensure that the choice between conflicting objectives adequately reflects the social priorities attached to the objectives. This is the problem of policy choice.

We have tried to recommend changes that would increase policy efficiency—costless improvements in the realization of at least some of our economic and social objectives. We have tried to avoid recommendations that involve policy choices—recommendations that, if adopted, would lead to the realization of one or more objectives at the expense of others.

We are convinced that the adoption of the tax system we propose would result in the more complete realization of the objectives of horizontal equity, vertical equity and allocative efficiency. Because we expect that the implementation of our proposals would have little net effect on aggregate demand and on the balance of payments, it probably would not affect the realization of the goals of full employment and price level stability one way or the other. If this expectation proved to be incorrect the policy instruments described and discussed in Volume 2 would be available to offset the expansionary or contractionary pressures that might be generated, if these were inappropriate under the circumstances, and to restore balance-of-payments equilibrium. But what would be the impact of the proposed tax system on the realization of the goal of increased economic growth?

#### Implications for Economic Growth

The adoption of our proposals would gradually bring about a reallocation of the stock of physical capital. Future investment would be relatively greater in industries and activities that have been unfavourably treated under the present system, and conversely. The resulting changes in the composition of the capital stock would enhance the rate of growth during the adjustment period. Because a protracted period of adjustment would be required—a matter of decades—the improved allocation of capital would raise the growth rate for a long period of time.

As we stated above, we believe that the adoption of our proposals would not reduce the propensities to save and invest. If this expectation proved to be correct the improved allocation of capital would bring about a costless increase in the growth rate. Even if our expectations proved to be overly optimistic, and these propensities were significantly reduced, it does not mean that the recommended system should be rejected or extensively modified. Just as any destabilizing effects of the proposed tax system could be offset by changes in other policies so too could any adverse effects of the adoption of the proposed system on the rate of capital formation be offset by changes in other policies.

The policies that might be adopted to offset any deleterious effects that the proposed tax system might have on the rate of capital formation are the same as those that should be adopted if, despite an increase in the growth rate as a result of implementing our proposals, an even higher growth rate was desired. Because we are confident that our proposals would not require these offsetting policies to maintain or surpass the past growth rate we will discuss them in the latter context.

#### Achieving Further Increases in the Growth Rate

The policy choice may be made that the rate of growth should be further increased even if this means reduced current consumption or increased reliance on foreign saving or both. This would not require fundamental modification of the proposed tax system.

As long as the other objectives are given any weight it is important that the pursuit of the goal of economic growth be carried out efficiently; a given gain in economic growth should be realized with the minimum cost in terms of the other objectives. There are two policy routes to the attainment of increased growth that involve minimum costs in terms of equity and efficiency:

1. The use of appropriate combinations of monetary policy, fiscal policy, public expenditures and exchange rate policy to increase both the national savings rate and its realization in productive investment. These policy combinations are discussed in Chapters 3, 4 and 5.
2. The use of general tax incentives for savings and investment. These instruments are described in Chapters 3 and 4.

It is obvious that the use of the first alternative does not involve any alteration of the tax reform package. The adoption of the second alternative, providing general tax incentives for savings and investment, should not necessitate any modification of the fundamental features of the proposed tax reforms, such as:

1. The integration of the corporation and personal income taxes.
2. The inclusion of capital gains in income.
3. The inclusion of gifts and bequests in income.
4. Elimination of the present discriminatory favourable treatment of certain industries.
5. The treatment of the family as the basic tax unit.
6. Replacement of the present manufacturer's sales tax with a general retail sales tax on all goods and services, with certain specified exemptions.

Moreover, some of the provisions that we recommend could be used to provide general tax incentives to savings and investment. These are:

1. Registered Retirement Income Plans provisions.
2. Accelerated capital cost allowances.
3. Standby investment taxes or tax credits.



The amounts allowed under Registered Retirement Income Plans could be liberalized to provide an increased incentive for savings. If necessary, recommended limits could be raised so as to convert the income tax system into what would be, in effect, an expenditure tax system. The existing capital cost allowance provisions, which already represent an acceleration of depreciation, could be further liberalized to increase the cash flow of corporations and to raise the marginal after-tax rate of return on investments. In addition, the special capital cost allowance provision for new and small businesses could be similarly liberalized.

While we do not recommend either a general tax on investment or a general subsidy to investment, or investment credit, we do recommend that the government consider using these tools on occasion for purposes of stabilization policy. If a general and continuing stimulus to investment was desired the government could enact a permanent investment subsidy or tax credit.

The adoption of these incentives for savings and investment would not, we believe, involve any conflict with the goals of horizontal equity or allocative efficiency. However, their adoption would mean that the goal of vertical equity would be less adequately realized. We would therefore recommend that if an increased rate of economic growth is desired, above and beyond the higher rate we would expect from the maintenance of full employment on the one hand and from the favourable effects on the allocation of capital of the adoption of the tax reform package on the other, it should be pursued through the use of the first policy alternative. The second alternative should only be adopted on a continuing basis if the first proved ineffective, that is to say, if investment was not sufficiently responsive to expansionary monetary policy but was responsive to the tax incentives we have discussed.

## CONCLUSIONS

## LABOUR EFFORT

1. Although we doubt that changes in the tax system could have a major impact on the quantity and quality of labour effort, we have been aware of the need to reduce tax barriers to greater effort, to remove tax incentives to emigrate from Canada and more equitably and effectively to encourage Canadians to undertake more education and training. By lowering the rates of tax on the return from additional effort people are encouraged to work longer and harder. The rate schedules we propose would have this effect. However, under our proposals average rates of tax would also be reduced for most taxpayers who depended primarily on wage and salary income. This change would be likely to discourage effort. The net effect is therefore indeterminate, although we believe it is more likely to be positive than negative.
2. The proposed reduction in the taxes paid by middle income families would substantially narrow or eliminate the adverse tax differential between Canada and the United States that now prevails for this group of taxpayers.
3. Under the proposed tax system married women with young children would be encouraged to enter the labour force because the marginal rates of tax on their earnings would be lowered. Married women without children would be faced with higher marginal rates, but the increases would not be appreciable.
4. The proposed treatment of the expenses of higher education would be both more equitable and more generous. It would make it much easier for students to borrow to finance their higher education because they could more readily repay after graduation. While concessions in the tax system may not be the best method of providing an incentive, the provision we recommend would be a vast improvement over the present provision.

5. We do not expect that adoption of the proposed system would bring about a drastic increase in the quantity and quality of labour effort in Canada but we have no doubt that the direction of change would be favourable.

#### ALLOCATION OF CAPITAL

6. Even in a world without taxes there are biases in the market that would distort the allocation of capital. Most of these non-tax distortions are best compensated for outside the tax system by other policies, such as combines policy. The tax system can, however, provide a reasonably efficient method of compensation for the market biases against new, risky investments.
7. The present tax system is lacking in neutrality. By applying different rates of tax to the income generated by different activities and by different kinds of assets, there is overinvestment in some industries and underinvestment in others. This reduces output. These tax distortions would be largely removed by adopting the comprehensive tax base, by giving residents full credit for taxes collected from organizations, and by treating losses more liberally.

#### ESTIMATES OF PROPOSED CORPORATION INCOME TAX CHANGES

8. Adoption of our proposals would increase corporation income tax collections by about 25 per cent. The increases would be attributable largely to the withdrawal of the dual corporation tax rate and the removal of some special industry tax concessions.
9. A large part of the increase would be imposed on corporate source income attributable to non-residents.
10. In the extractive industries the proposed tax increases would be large relative to capital expenditures.



## LARGE, RESIDENT-OWNED CORPORATIONS WITH NO SPECIAL TAX CONCESSIONS

11. For these corporations the tax increases at the corporate level would be relatively small and the tax reduction at the shareholder level would be substantial, despite the full taxation of realized share gains.
12. The net effect of these changes in the tax treatment of corporate source income would be to increase the after-tax income from equities for most resident shareholders. Because the return for most other assets would be taxed at least as heavily as at present the relative attractiveness of Canadian equities would be increased. Share prices would rise.
13. With higher share prices management would find that a lower before-tax rate of return on additional corporate assets would provide their shareholders with as high a rate of return as they could obtain from other assets. Capital formation would be stimulated.
14. To finance a more rapid rate of expansion these corporations probably would rely more heavily on retained earnings and new equity issues, although the increase in the former is likely to be much greater than the latter. The reliance on debt financing would probably decline relatively.
15. Although cash dividends would probably not fall absolutely, pay-out ratios would gradually decline.

## OTHER BUSINESSES

16. Most large non-resident-owned corporations not now receiving special tax concessions would not be affected one way or the other by the adoption of our proposals. They might rely more heavily on Canadian equity financing than in the past.

17. A few large Canadian mining and petroleum companies would be seriously affected by the removal of depletion and the three-year exemption for new mines. The impact would, however, be gradual. Smaller corporations that did not have other operating income would not be subject to major changes in after-tax rates of return at the corporate level. The capital expenditures of the former probably would be reduced, but there would be little change with respect to the latter—particularly where the corporation income tax increases would be offset by reduced taxes at the shareholder level.
18. Small corporations would be adversely affected by the removal of the dual rate of corporation income tax if compensating changes were not introduced. The integration of corporation and personal income taxes, accelerated capital cost allowances for new and small businesses and the proposed treatment of losses would provide more effective incentives at lower revenue cost.
19. Unincorporated businesses would benefit from lower personal rates, accelerated capital cost allowances and the more liberal treatment of losses, but would be hurt by the more stringent treatment of personal benefits and the full taxation of property gains. On balance the capital expenditures of rapidly expanding, small, risky businesses, whether incorporated or unincorporated, would be encouraged.
20. The full taxation of property gains and a reduced availability of mortgage money would make investments in real estate, other than owner-occupied housing, less attractive.

## BUSINESS SAVING

21. Considered as a group the pay-out ratios of corporations in the extractive industry would be unlikely to change, although there probably would be large variations among corporations. This would mean that about one half of the increase in tax on corporations in the extractive industries would be reflected in reduced business saving. In other industries we expect that pay-out ratios would gradually decline to the point where total business saving would be unchanged despite the increase in corporation income tax collections. In particular, large resident-owned corporations would be able to maintain their present cash dividends despite an increase in earnings because the cash position of most shareholders would be substantially improved by the full credit for corporation income tax on corporate earnings, whether distributed in cash or not.

## PERSONAL SAVINGS

22. The increased progressiveness of the recommended personal income tax system would substantially change the disposable income of some tax units. A large part of the tax increases for those with high incomes would be financed through reduced personal saving; a large part of the tax reductions for those with low incomes would be spent. The reduction in cash dividends brought about by reduced corporation pay-outs would also reduce disposable income and personal saving. Implementation of the proposed sales tax changes would have virtually no effect on personal saving.
23. The recommended treatment of life insurance and Registered Retirement Income Plans would make insurance saving less attractive and Registered Retirement Income Plan saving more attractive. The postponement of tax on the latter would be equivalent to a tax reduction of about \$50 million. The taxation of life insurance companies on the same basis as other companies would reduce their



cash flow by about \$75 million. Assuming that the tax reduction on retirement savings would be added to personal saving and the tax increase on life insurance would be deducted from personal saving the net effect would be a reduction in personal saving of about \$25 million.

24. Although we estimate personal saving in total would decline only by about \$135 million, less than 5 per cent of the total, the form of personal saving would be dramatically altered. A much larger part of personal saving would be channelled into the purchase of new equities and less into the purchase of fixed income assets.

#### THE RATE OF SAVING AND INVESTMENT

25. The reduction in personal saving would be more than offset by an increase in government saving, for the estimates given in Chapter 35 suggest that government revenues would be raised by over \$200 million. With no change in business saving and no change in Canada's reliance on foreign saving we expect that the volume of saving and investment would be little changed by the adoption of the proposed tax system.
26. If the tax changes had any net impact they probably would increase the propensity to invest relative to the propensity to save, thus stimulating the economy. Changes in other policies could be made to offset this effect if it were not appropriate at the time.

#### BALANCE OF PAYMENTS

27. The adoption of the tax reforms probably would have little direct impact on imports and exports of goods and services. But the non-merchandise items in the current account would likely be affected as a result of changes in corporate distributions and by changes in the capital account.
28. The composition of the international capital flows probably would be substantially altered. Although foreign direct investment in Canada

is unlikely to decline except in the extractive industries, foreign direct and portfolio investment by Canadians probably would be reduced because the relative attractiveness of Canadian investment would be increased. Canadians would sell their portfolio holdings in foreign corporations to non-residents and non-residents would tend to sell their Canadian portfolio holdings to Canadians. Non-residents would hold more Canadian fixed interest-bearing assets. Lower Canadian bond prices brought about by a shift from bonds to equities by residents would induce non-residents to hold more Canadian bonds and would tend to increase the net capital inflow unless offset by changes in monetary policy.

#### GROWTH IMPLICATIONS

29. We believe that the adoption of our proposals would not affect the rate of investment but would greatly improve the allocation of capital. This would increase the rate of growth over a long period without forcing Canadians to consume less or rely more heavily on foreign saving.

In the unlikely event that the rate of investment was reduced or that Canadians wanted an even higher rate of growth, despite the costs involved, this could be achieved efficiently and equitably without modifying the fundamental features of the tax system we propose.

## REFERENCES

- 1/ In technical parlance, this policy would give rise to an income effect in favour of leisure which would swamp the substitution effect brought about by the lower marginal rates.
- 2/ See Appendix I to Volume 3 and Appendices D and F to J. Bossons, Changes in Direct Taxes On The Components of Income, a study published by the Commission.
- 3/ In so far as individuals were hurt by the reforms, they, of course, would bear a cost.
- 4/ We must emphasize that the relevant rates of return are both marginal and social. In contrast, readily available statistics provide estimates of average private rates of return. These differ from the rates of return applicable for optimum investment in two ways:
  - a) The available rates include profits on investments that are more or less profitable than the rate just sufficient to induce them.
  - b) The available rates do not take into account the external costs imposed upon firms and individuals other than those realizing the return or the external benefits reaped by those other firms and individuals.
- 5/ We do not deny that there may be a conflict between vertical equity and economic growth. However, we believe that if such a conflict exists it is because of the effect of progressive taxes on the volume rather than on the allocation of savings.
- 6/ For a discussion of how integration would increase cash retentions of corporations, see below.
- 7/ This estimate of the average effective marginal tax rate for mining corporations is based on a definition of income that does not allow



the deduction of depletion and only allows expenses to be written off at the same rate as in other industries; in addition it reflects the fact that the marginal rate of tax is zero in the first three years of production.

- 8/ This figure does not reflect the elimination of the taxes on section 105 distributions of \$6 million. This has been ignored because of the difficulty of allocating this amount by industry. It is important to recognize that the estimated tax increases are increases in corporation income tax collections. Most resident shareholders would have their taxes on corporate source income reduced.
- 9/ "Integrated" companies are those that are involved in the developing, producing, refining and retailing of mining and petroleum products.
- 10/ We use the word "large" to denote corporations with current average tax rates of 45 per cent or more.
- 11/ For a description of the evidence underlying the assumption that goodwill gains equal corporate retentions that in turn equal cash dividends, see Note 21 in Appendix A to this Volume. Additional discussion of the validity of this assumption for large corporations, and the extent to which it can be extrapolated to future years, is contained in J. Bossons, Rates of Return on Common Stocks: Dividends, Retentions and Goodwill Gains, a study published by the Commission.
- 12/ While there are limitations on the extent to which existing data can furnish a basis for estimating the extent to which the tax changes we propose are likely to be shifted, some conclusions may nevertheless be deduced. The short-run shifting of the corporation income tax has been analyzed in R. Levesque, The Incidence of the Corporate Income Tax: A Cross-Section Analysis, a study published by the Commission. Levesque's evidence indicates that in the short run roughly one third of corporation taxes were shifted through changes in product and factor prices. This

evidence relates only to changes in taxes levied at the corporate level. Under our proposals the changes at the corporate level would be insignificant for large corporations other than those receiving special concessions. The important tax changes resulting from our reforms would occur almost entirely at the personal level. We expect that if these tax changes were shifted at all they would be shifted to a much smaller extent than if they occurred at the corporate level. As has been stressed in Chapter 19, we define tax shifting to exclude the effect of long-term capital adjustment resulting from a tax change; the effect of the unshifted portion of the tax change on investment is in fact what we analyze in this chapter.

- 13/ The estimates are provided in Appendix G to J. Bossons, Changes in Direct Taxes on the Components of Income, a study published by the Commission.
- 14/ By a "marginal investor" we mean an investor who seeks neither to buy nor to sell a given stock at a given market price. For such an investor the stock's market value corresponds to his evaluation of its present worth. At different market prices different potential investors in a security are, of course, indifferent as to whether they hold or do not hold the security. At any given market price some participants in the market would desire to buy the stock and some to sell. Because the price of a stock has to clear the market it must be between the highest price at which potential buyers would buy and the lowest price at which potential sellers would sell. A marginal investor might be termed the potential buyer most likely to buy if the stock's price fell or the potential seller most likely to sell if a higher price were bid for the stock.
15. We use the term "capitalization rate" to refer to the rate of return after corporation and personal income taxes that is required by a marginal investor. Because of the variability of personal tax status

among investors, many analysts prefer to look at the rate at which income after corporation income tax but before personal income tax is capitalized by the market. This latter rate is dependent both upon the capitalization rate, as we define it, and upon the personal income tax status of marginal investors; it is consequently altered by our reforms even if the capitalization rate, as we define it, is not.

16/ We assume for the sake of simplicity that the expectations held by marginal investors concern the magnitude of an even flow of income for an indefinite number of years. The analysis that we apply to such expectations applies to any other form of expectation about a corporation's future earnings stream; indeed it can be shown that for a given capitalization rate a perpetuity can be found for any expected income stream that is equivalent to that income stream in the sense that it will be capitalized at the same market price. For a more detailed analysis of the valuation model underlying the analysis of this section, see M. H. Miller and F. Modigliani, "Dividend Policy, Growth and the Valuation of Shares", Journal of Business, October, 1961.

17/ The determination of market capitalization rates is a complex general equilibrium problem, and we cannot hope to prove in a few sentences that capitalization rates would remain unchanged. If the only implications of our proposals were to increase the after-tax income derived from a particular class of assets, we would expect the capitalization rate on that class of assets to rise and capitalization rates on other asset classes to fall. Such changes in capitalization rates would partially offset the changes in asset prices that would otherwise result from the changes in after-tax incomes derived from equities. In fact, however, the effects of our proposals are much more complicated. First of all, the nature of corporate equities as an investment asset would be changed because of the decreased risk resulting from the effects of the increased loss write-offs permitted under our



proposals; the decreased risk would result in a decrease in the capitalization rate that would offset, to a greater or less extent, the increase previously noted. Secondly, the relative decline in after-tax income from other assets resulting from our other recommendations would also cause the capitalization rate on corporate equities to rise. It is not unlikely, therefore, given the probable cross-elasticity of demand for corporate equities with respect to changes in prices of fixed income securities and the elasticity of demand for corporate equities themselves, that the change in equity capitalization rates resulting from the decreased demand for fixed income securities would more than offset the increase in capitalization rates that would result from the change in after-tax income from equities alone. If any change in capitalization rates for corporate equities occurred, it would more likely be a decrease than an increase. Again it must be emphasized that by capitalization rates we refer to the capitalization rates applied to income after both corporation and personal income taxes have been deducted.

18/ Needless to say, decisions to retain earnings are made by a corporation's directors, not by its shareholders. A board of directors may not do what even a majority of shareholders may desire, especially in cases where effective control of a corporation rests with its managers because of the broad distribution of ownership. Nevertheless, most boards of directors are responsive to shareholder pressures and oriented to shareholders' interests.

19/ Among other things, the example assumes that no "goodwill" gains are expected. Goodwill gains arise because of unexpected changes in income or because future income is discounted more heavily to reflect the investor's assessment of the risk associated with the expectation. If income in the event were greater than the risk-discounted anticipation a goodwill gain would arise that would be taxed under the proposed system.

- 20/ "Dilution of earnings" is defined as follows: if the sale of shares to finance a new investment results in a drop in expected earnings per share, dilution has occurred.
- 21/ Shareholders would bring into income \$1 million and have a personal income tax liability of \$400,000, assuming a marginal personal rate of 40 per cent. Against this liability the shareholders would be given a refundable tax credit of \$500,000 with respect to taxes collected at the corporate level. A refund of \$100,000 would thus be available to the shareholders.
- 22/ The share gains would in this case be precisely offset by the increase in the cost basis of the shares resulting from the allocation of earnings to shareholders in accordance with the procedures outlined in Appendix H to Volume 4. Consequently these gains would not engender additional tax liabilities for the shareholders of the corporation.
- 23/ This statement is predicated upon two propositions:
- a) the tax reforms would reduce the effective rate of tax on the returns from most marginal investments; and
  - b) investment is sensitive to a change in the after-tax rate of return at the margin.

We have already assessed the evidence bearing upon the first proposition, and have concluded that the tax reforms would reduce the tax burden to the ultimate stockholder on marginal investment. If we view this change from the standpoint of the firm rather than from the standpoint of the ultimate stockholder, it takes the form of a reduction in the marginal cost of capital to the firm.

Most recent empirical studies that have investigated the influence of the cost of capital upon investment have used the market rate of interest as a measure of the cost of capital. While some studies have attempted to incorporate variables that take into account the

imputed cost of increased risk brought about by an increased use of borrowed funds, few studies have adequately taken into account important dimensions of the tax structure. Consequently, one must infer the probable effect of changes in the tax structure from the estimated effect of changes in other variables which influence the cost of capital, the most prominent of which is the market rate of interest.

In addition, the reader should bear in mind that most of the empirical analyses of investment are concerned with the effects of transitory changes in the cost of capital. The tax changes we propose would result in long-run changes in the cost of capital that probably have a greater impact than transitory changes.

Several recent empirical studies of investment in the United States have overturned the earlier empirical findings that the rate of interest has a negligible effect on investment. When the lag of the investment process is reasonably adequately specified, a moderately strong effect of interest rates upon investment is revealed. While the Canadian quarterly data required for estimating such a model are not available in adequate detail, an analysis of the aggregate data carried out by our staff is consistent with the recent United States findings.

For a synopsis of the recent empirical work in the United States and for a discussion of the Canadian results, the reader is referred to T. A. Wilson and N. H. Lithwick: The Sources of Economic Growth, a study published by the Commission.

24/ For a more detailed statement of the economic model underlying the propositions stated in this section see F. Modigliani and M. H. Miller, "Some Estimates of the Cost of Capital to the Electric Utility Industry, 1954-1957", American Economic Review, June, 1966.



- 25/ For this purpose cash flow does not include amortization payments because it is assumed that these amounts would be just offset by new borrowing.
- 26/ In this analysis we assume that interest rates would not be changed as a result of our proposals.
- 27/ It would be in the interest of resident shareholders that corporations allocate, as distinct from distribute, virtually all of their current earnings, for allocation would confer the refundable credit for corporation income tax. The methods of allocation that we propose are described in Appendix H to Volume 4. In addition, earnings allocated but not distributed would be added to the cost basis of shares so that the share gains resulting from retentions would only be taxed at the marginal personal rate of the shareholder. Unallocated retained earnings would be taxed to the corporation and again to the shareholder on the sale of his shares.
- 28/ Our primary reason for assuming only a gradual decline in pay-out ratios is that we doubt that many managers would wish to reduce dividend payments even though it would be profitable for most shareholders if the corporation did so and thereby avoided the costs of new issues. We assume however that such managers would be more likely to avoid raising dividends as corporate earnings increased as a result of the increased attractiveness of investments in corporate assets.
- 29/ Life insurance companies are not discussed in this section but are considered later in the chapter.
- 30/ The attribution of corporation profits and taxes paid would not affect the tax position of non-residents. It might also be possible to pay stock dividends without unfavourable consequences if the position of the non-resident was protected by treaty arrangements.

- 31/ "Capital expenditures" in this context are as reported in the Taxation Statistics and represent the capitalized expenditures on depreciable fixed assets. It includes the preproduction expenses of mining and petroleum companies but generally excludes land.
- 32/ Life insurance companies are discussed later in the chapter.
- 33/ See Appendix I to Volume 3 and Appendices D and F to J. Bossons, Changes in Direct Taxes on the Components of Income, a study published by the Commission.
- 34/ J. Bossons, Who Benefits and Who Pays: The Incidence on Different Income and Occupation Groups of Income Tax Changes Resulting from the Commission's Recommendations, a study published by the Commission.
- 35/ The refunds of corporation tax to resident shareholders are included in the changes in personal income tax given in Table 37-10.
- 36/ Detailed estimates of tax changes on different components of investment income for resident individuals classified by income and by the importance of each component are presented in J. Bossons, Changes in Direct Taxes on the Components of Income, a study published by the Commission.
- 37/ This does not mean that share prices would decline absolutely. Share prices rise in part as a result of the retention of earnings. For this reason even if yields declined gradually the prices of shares would be unlikely to decline.
- 38/ Cash flow rate of return includes cash dividends plus any corporation income tax refunds and does not include any realized or unrealized gains in share values.
- 39/ Trusteed pension plans in 1963 had total assets of \$5.3 billion of which \$0.75 billion, or 14 per cent, were in Canadian equities. United States corporate pension plans now hold about one half of their assets in

equities. Given that Canadian pension funds now have substantially greater assets than in 1963, it is apparent that if they moved toward the United States percentages they would absorb a massive volume of equities.

40/ During the period immediately following the enactment of our proposals the fiscal and monetary authorities would have to be particularly vigilant because the effects upon aggregate demand during the transitional period are particularly difficult to foresee. Prompt action to offset changes in aggregate demand might be required.

41/ Short-term capital movements involve changes in domestic holdings of foreign deposits and short-term foreign liabilities, such as treasury bills of foreign governments and commercial paper, and changes in foreign holdings of Canadian dollar deposits and Canadian short-term liabilities. The long-run direct effect of the tax reforms upon these flows would be negligible, for the tax reforms would have no significant impact upon short-term interest rates. During the transitional period, however, short-term capital flows might change in response to changes in other capital flows, in anticipation of aggregate demand effects, and as a result of the general uncertainty about the overall effects of the tax reforms.

42/ See Chapter 5.

43/ In addition, Canadian corporations would be encouraged to increase the volume of new equity issues and to reduce the volume of new bond issues as the yields on equities fell and the yields on bonds rose, further mitigating these price adjustments.

44/ By positive or negative impact we mean that there would be an induced rise or decline in official reserves at the given exchange rate unless offsetting monetary policies were adopted.



45/ Based on an updated input-output table for 1959 prepared for the Commission by J. Sawyer.

46/ See G.D.A. MacDougall, "The Benefits and Costs of Private Investment: A Theoretical Approach", Economic Record, Vol. 36, 1960, pp. 13-35, for a discussion of how the receiving country benefits from the capital inflow. A shift of Canadians' investment from foreign to domestic capital expenditures improves the rate of growth because the before-tax yield of the capital expenditures benefits Canada in the latter case whereas only the after-tax yield accrues to Canadians in the former case.

## FEDERAL-PROVINCIAL IMPLICATIONS

The purpose of this chapter is to consider some of the implications for federal-provincial fiscal relations of the tax structure recommendations made in Volumes 3, 4 and 5. No attempt is made to repeat the conclusions and recommendations made in Volume 2 that have relevance for federal-provincial relations 1/.

The principal technical problem in federal-provincial tax relations is the harmonization of federal and provincial taxes of various kinds and of arrangements for their collection. This problem is discussed in this chapter. The questions of whether the federal government can or should impose taxes on commercial and industrial corporations controlled by the provinces, and whether the provinces can or should tax similar corporations owned by the federal government, were discussed in Chapter 20.

In trying to devise a federal tax system we are forced to consider a very large part of the tax structures of the provinces because much of each province's tax structure is the same as or similar to the federal tax structure. Any change in the federal tax structure, therefore, has significant implications for provincial taxation. For example, the federal personal income tax base and the provincial income tax bases are either identical or very similar. To recommend a change in the federal income tax base is tantamount, therefore, to recommending a change in provincial income tax bases. In our view it would be a tremendous loss to all Canadians if this common income tax base was not maintained. To recommend that the federal government move from a manufacturer's sales tax to a retail sales tax obviously is of great significance to the provinces because most of them now impose a form of retail sales tax. We are persuaded that great advantages would be gained if the provinces and the federal government were to adopt a common retail sales tax base.

Even greater uniformity of tax bases than now prevails among governments would be highly desirable, as would uniformity of rates. Indeed, our proposed federal tax system would fall far short of the objectives we have sought if the provinces and the federal government were unable to harmonize rates of tax on a common income tax base. In particular, our recommendations with respect to the integration of corporation and personal income taxes would lose some of their effectiveness unless co-ordinated rates were applied at both levels of government. Likewise, some of the advantages of including gifts in the personal income tax base would be lost if the provinces continued to impose death taxes.

Canada should avoid, if possible, the duplication of administrative and compliance costs that may result when the federal and provincial governments levy essentially the same kind of tax on the same taxpayers. It is most desirable that agreements be reached between the federal and provincial governments for the collection and administration of each type of tax by one or the other in a way that protects the interests of both.

We are under no illusions that it would be an easy matter to achieve common tax bases, harmonized tax rates and joint tax collection arrangements. The drive for greater provincial autonomy is extraordinarily strong. The desire to have complete fiscal independence for each province as a matter of right, and as a tool for achieving provincial objectives, would make it difficult to persuade some of the provinces to work more closely with the federal government and other provincial governments in the tax field. The potential gains from success are so great, and the potential losses from failure so heavy, that we have no hesitation in urging the federal government to strive to attain these goals despite the serious obstacles that may be encountered.

In arriving at the conclusions and recommendations given in this chapter, we have been guided by the following considerations:



1. The federal government must continue to have the major voice in the determination of personal and corporation income tax bases. While consultation with the provinces is essential, particularly now that the provinces obtain such a large share of personal income tax revenues, the federal government must be more than a benevolent chairman of a committee of the provinces. This is also true, but to a lesser extent, with respect to sales taxes.
2. The federal government must ensure that the tax system does not become either a weapon with which the strong provinces tyrannize the weak provinces or a means of erecting barriers between provinces.
3. Although it has no constitutional obligation to do so, the federal government has taken primary responsibility in the past for the redistribution of personal income. It has determined the progressiveness of the personal rate structure, and federal transfer payments have been largely responsible for offsetting regressive property taxes. At least until the provinces take a greater interest in the redistributive effects of the tax system, the federal government should continue to assume this responsibility.
4. As we recommended in Chapter 3, the federal government should resist further increases in personal income tax abatements in order to keep the personal income tax as an effective tool of discretionary fiscal policy. Only when a joint stabilization strategy is developed, and the provinces can play an effective stabilization role in co-operation with the federal government, should this restriction be relaxed.
5. The relative importance of sales and property taxes in the overall Canadian tax mix should gradually be reduced. This would not hurt Canada's international competitive position or the rate of economic growth, but would improve the equity of the Canadian tax system. If, over time, the proposed tax system did not yield adequate government

revenues, personal income taxes should be raised. If tax cuts were required to offset the revenue drag, sales and property taxes should be reduced. Because of the greater long-run elasticity of income taxes, persistent adherence to the foregoing rules would, in our opinion, substantially improve the tax mix.

#### PERSONAL AND CORPORATION INCOME TAXES

Under the existing Federal-Provincial Fiscal Arrangements Act 2/ the federal government has agreed to collect personal income tax on behalf of all the provinces except Quebec, and corporation income taxes on behalf of all the provinces except Quebec and Ontario.

The participating provinces levy personal and corporation income taxes on a base that is identical to that defined by the federal Act so as to ensure uniformity in the administration of the tax laws. Under the 1966 arrangements, all provinces except Manitoba, Saskatchewan and Quebec levy personal tax at a rate of 24 per cent of the federal tax, this being the amount allowed as an abatement from the tax imposed by the federal government. In most provinces, therefore, a taxpayer deducts from his federal tax exactly the amount of the provincial tax which he is called upon to pay and there is no additional provincial tax beyond the federal rates. In Manitoba and Saskatchewan, the personal rates are 29 per cent of the federal tax, so that residents in those provinces pay additional provincial taxes equal to 5 per cent of the federal tax.

Quebec residents receive an abatement of 47 per cent instead of 24 per cent of the federal tax. The Quebec rates, when applied to the Quebec personal income base, result in a tax that is approximately equal to the federal abatement. Therefore, Quebec residents effectively pay no additional provincial tax. The higher abatement available to Quebec residents, which is balanced by the higher rates of provincial tax, results from that province taking advantage of the so-called "opting-out" formula. In exchange

for the higher abatement, Quebec undertakes to administer and finance the federal share of certain existing welfare programmes, including youth allowances to students of 16 and 17 years of age, hospital insurance, special welfare grants, technical training grants and health grants.

The federal abatement of personal income tax applies to "income earned in the taxation year" in a province and rules for determining such income are set forth in the Regulations. The basic rule is that an individual's income is deemed to have been earned in the province in which he resided on the last day of the year. The only exception is where the taxpayer has business income arising from a "permanent establishment" located outside his province of residence, in which case the income attributable to that permanent establishment is deemed to be income earned in the place where the permanent establishment is located. The rules for allocating income among several permanent establishments are virtually the same as those for corporations, to which reference is made below 3/. There are special rules for determining income earned in a province in the case of non-residents of Canada and of persons who reside in Canada for only part of the year.

On the corporate side, tax room is provided to the provinces by means of a tax credit equal to 9 per cent of corporate taxable income earned in a province rather than as a percentage of the federal tax. The credit is 10 per cent in Quebec. The additional percentage point available to Quebec corporations is in lieu of federal grants to universities in that province. The corporation tax rates currently in effect are shown in Table 38-1.

The federal credits for provincial corporation income taxes, and the provincial taxes themselves, are based on the taxable income of each corporation earned in a particular province. A corporation can have income earned in a province only if it has a permanent establishment therein; the income of corporations with permanent establishments in more than one province is allocated among those provinces according to a formula set out in the federal Regulations 4/. The formula takes into account the gross revenue attributable



TABLE 38-1

## RATES OF TAX ON CORPORATE INCOME

	First \$35,000 of Income					Income in Excess of \$35,000				
	Federal Tax on Corporate Income	Federal Old Age Security Tax	Federal Credit for Provincial Tax	Provincial Income Tax	Total Tax	Federal Tax on Corporate Income	Federal Old Age Security Tax	Federal Credit for Provincial Income Tax	Provincial Income Tax	Total Tax
Quebec	18	3	-10 a/	12	23	47	3	-10 a/	12	52
Ontario	18	3	- 9	11	23	47	3	- 9	11	52
Manitoba and Saskatchewan	18	3	- 9	10	22	47	3	- 9	10	51
Others	18	3	- 9	9	21	47	3	- 9	9	50

Note:

a/ The greater tax credit for Quebec is granted in lieu of federal university grants.

to each permanent establishment and the wages and salaries paid to employees of each permanent establishment. Special provisions are made for certain special types of corporations, such as financial and transportation corporations.

The use of a formula to allocate business income among the provinces has enormous advantages. All business income is subject to provincial taxation but no business income is taxed by two or more provinces. Consequently, interprovincial "double taxation" is avoided. Just how complicated interprovincial taxation could become, if business income was not allocated by formula, is well illustrated by the problems of international taxation which we discussed in Chapter 26.

Another important factor in the formulation of the present system was the stipulation by the federal government that it would collect income taxes for the provinces only if the provinces adopted tax bases identical with that of the federal government. Without this stipulation, the degree of uniformity in income taxes that we now enjoy probably would not have been achieved. The substantial differences among state income taxes in the United States provide a forceful demonstration of what can happen in a federal system.

#### Common Income Tax Base

We believe that it is extremely important that the provinces and the federal government continue to maintain a common, or virtually common, personal income tax base. But we also believe that the common base should be more comprehensive than the present base and should embody the reforms we have recommended elsewhere in this Report. Broadening the base and eliminating the inequities, anomalies and loopholes in the present structure should be as attractive to the provinces as to the federal government. A base thus improved would allow all governments to raise the same revenues with lower rates or more revenues with the same rates. The merits of this result do not need to be extolled.

Under the existing arrangements the residents of some of the provinces are paying a large part of their income taxes to their provincial governments. Consequently, the provinces cannot be expected to accept meekly whatever tax changes the federal government decides unilaterally to make in the base. It is obvious that federal-provincial agreement on substantive tax base changes is an inescapable necessity if a uniform base is to be maintained. And without a virtually uniform base there would be a real danger that the tax system would degenerate into an agglomeration of eleven un-coördinated and competitive tax systems. This would be disastrous.

This is not to say that joint decision making would be easy or without dangers. Governments would be called upon to exercise a high degree of maturity and responsibility and to put aside sectional interests in the national interest. If they did not rise to the occasion, we would either lose the common income tax base that is so beneficial to all taxpayers and all governments, or the process of change would become so entangled in controversy that changes in a common tax base to meet changing circumstances would become impossible. Even if all governments agreed on a common tax base, joint decision making without a profound realization by all governments of their responsibilities could easily result in a tax structure that would be both inequitable and difficult to reform because of special provisions for sectional interests.

#### Administration of Income Taxes

There can be no doubt that life would be simpler for taxpayers, and administrative costs would be reduced, if each type of tax levied by both levels of government was collected on a common base by one of them on behalf of both. The possibility of working out such collection arrangements that would include all provincial governments should be carefully and fully explored. It seems to us that under joint collection arrangements both levels of government should make collection policy decisions jointly and that the level of government not acting as the collection agency should have



the right to all the information necessary to protect its interest. This would include the right of the non-collecting government to audit the work of the other.

If our recommendations are accepted there will be three tax fields in which the federal and provincial governments will have a mutual interest: personal and corporation income taxes and retail sales taxes. We should like to see the federal government act as the collection agency for all personal and corporation income taxes 5/ and the provincial governments act as the collection agency for all retail sales taxes. In this event the federal government would act as the collection agency for Quebec with respect to personal and corporation income taxes and for Ontario with respect to corporation income taxes. Provincial death taxes would be abolished. The provinces now collecting sales taxes would also collect sales taxes for the federal government. The provinces not now collecting sales taxes would either begin to collect sales taxes for the federal government (and for themselves if they wished to do so) or the federal government would establish collection machinery in those provinces.

#### Integration of Personal and Corporation Income Taxes

Under our proposal for the full integration of the taxes on personal and corporate income, resident individuals to whom corporate distributions or allocations were made would be given full credit for the tax paid at the corporate level. For resident shareholders the Canadian corporation tax would be, in effect, simply a withholding tax.

Although it would involve a radical change from the present system, and might be unacceptable to the provinces on doctrinal grounds, there can be no doubt that from every other point of view it would be highly desirable that the provinces withdraw from the corporation tax field altogether. Provincial revenues could be maintained in several ways. For example, part of the

corporation tax revenues raised by the federal government could be allocated among the provinces by a mutually acceptable formula. Another possibility would be for the federal government to reduce its retail sales tax rate (assuming that it moved to the retail sales tax from the manufacturer's sales tax) in exchange for the withdrawal of the provinces from the corporation tax field. Because the long-run elasticities of the corporation income tax and the retail sales tax are about the same, the future growth of provincial revenues would not be reduced by such mutual concessions.

If the corporation income tax was solely a federal tax, integration of the personal and corporation income taxes would be a straightforward matter. The federal government would collect the corporation tax and give all resident shareholders full credit for that tax against their federal personal income tax liabilities. If this credit resulted in a refund, the refund would be applied in payment of the provincial personal income tax to the extent thereof and would be remitted to the province along with personal income tax revenue collected on behalf of the province.

We urge the federal government to attempt to negotiate with the provinces for exclusive use of the corporation income tax. The reduced costs of taxpayer compliance, the greater simplicity of the system and the elimination of duplicate tax administrations in Quebec and Ontario would be a long step forward. While the imposition of a corporation income tax can be justified on various grounds, as we point out in Chapter 19, it serves no useful social purposes, so that the provinces would not be relinquishing an effective instrument for social reform by ceasing to levy such a tax. The provinces could achieve all of their economic purposes by granting subsidies to businesses rather than corporation tax concessions. If the sole purpose of a provincial corporation income tax is to raise revenue, and if the same revenue can be obtained in other ways, there seems to be no essential reason for the provinces to continue that tax.

Should it prove impossible to negotiate a withdrawal of the provinces from the corporation income tax field, the next best alternative would be for the federal government to grant full credit to resident shareholders under the integration proposal for both the federal tax and a standard rate of provincial corporation income tax. The competition among the provinces to induce businesses to locate within their boundaries would be likely to restrict the variations of provincial corporation income tax rates from the standard rate within a fairly narrow compass. Under this alternative, the use of the present formula for the allocation of business income among the provinces should be maintained.

An unsatisfactory state of affairs would result if the provinces continued to levy corporation income taxes at different rates, with the federal government granting shareholders a credit only for its own corporation income tax it levied. This would lead to the situation where a shareholder resident in province A would be at a tax disadvantage if he bought a share of a corporation resident in province B. It would not be long before shareholders would demand credit for the taxes imposed by "foreign" provinces, and there would be an endless debate about the rights and duties of source and destination provinces. The system would be an administrative nightmare.

#### Harmonization of Rates of Personal and Corporation Income Taxes

Under our integration proposal, it is crucial that the total tax rate on corporate income be approximately the same as top marginal combined rate of federal and provincial personal income taxes. If the combined personal rate was higher than the total corporate rate by more than, say, 5 per cent, high income taxpayers would find it advantageous to postpone part of their personal income taxes by retaining earnings in corporations. Given the rules existing at present in a number of countries in respect of foreign tax



credits, it is also important that the present combined rate of tax on corporate income, ranging from 50 per cent to 52 per cent, not be changed materially. For most "direct" investment in Canada by non-residents, a rate reduction would have the effect of merely transferring revenue from the Canadian treasury to the treasuries of other countries. A rate increase would be borne generally by the non-resident investors themselves, and so would discourage investment in Canada. There are thus two important restrictions on the top marginal combined rate of federal and provincial personal income taxes.

We have presented a personal income tax rate schedule that, if imposed on our suggested base, would raise about the same revenues, both federal (including old age security tax) and provincial, as the present system. It will be recalled that this proposed rate structure has a top personal rate of 50 per cent. If this rate schedule was put into effect, it would forestall many complaints about the disincentive effects of the progressive tax system and would permit a wholesale reform of the tax base. The Canadian corporate source income of non-residents could be taxed by Canada at these rates without discouraging foreign investment. We shall assume for the purposes of this discussion that, if the recommended base were taxed at these suggested rates, there would be "sufficient" revenue from income taxes for both the federal and provincial governments.

How the two levels of government share these personal income tax revenues is not our concern. But we are vitally concerned that the level of the federal and provincial personal income tax rates, and the relationships between them, should not open avenues for tax postponement by upper income individuals.

With all this in mind, we suggest that the federal government continue to act as the collection agency for all personal income taxes. Furthermore, we would favour an arrangement that embraced the following propositions:

1. As at present, there should be uniform personal income tax rate schedules 6/.
2. The rate of corporation income tax should be equal to the top marginal rate of personal tax.
3. As at present, the federal government should allow an abatement for provincial personal income taxes. It would not be essential from a technical point of view that the abatement be the same for all provinces.
4. This abatement should be calculated on the "basic tax" (base times the rate structure) before any credits for other taxes were granted.
5. As at present, each province should set a rate of personal income tax as a percentage of the basic tax.
6. The only limitation on the provincial tax rates would be that the rate set by any province would not exceed the federal abatement to that province by more than about 5 percentage points. This limitation would keep the spread between the top marginal rate of tax, as given in the federal rate schedule, and the maximum combined rate of federal and provincial taxes, to within 5 percentage points. If the federal government then taxed corporate income at the top personal rate on the schedule, no taxpayer could postpone more than 5 per cent of his combined federal-provincial personal income tax. We believe that this would not create significant avoidance opportunities for upper income shareholders.

We are well aware of the disadvantages of linking the federal and provincial personal income tax rates in this fashion. We dislike the limitation that would be required on the extent to which provincial income tax rates could exceed the federal abatement. It is sometimes argued that separate federal and provincial rate schedules would avoid the charge that the federal government was imposing "double" taxation when a province increased its rate of tax so as to exceed the federal abatement. Similarly, separate schedules

might clarify for the taxpayer the levy by each government. Despite the calculations required on the present income tax form, many taxpayers apparently do not understand that federal and provincial income taxes are being collected simultaneously by the federal government in most provinces.

However, too much should not be made of the rigidities of our approach. The fact is that, in general, the provinces seem to be anxious to avoid substantial tax differentials, as evidenced by the fact that the difference between the federal abatement and the highest provincial tax is at present only five percentage points.

It would be most unfortunate if the simplicity of the common personal rate schedule were abandoned in an attempt to preclude the "double" taxation argument, for this argument is essentially meaningless. To describe the situation where a provincial income tax rate is in excess of the federal abatement as a form of "double" taxation implies that taxes are in some sense being compounded. This is not the case. Raising the provincial income tax rate above the federal abatement is equivalent to an across-the-board percentage increase in the marginal rates on the schedule. This simply increases personal income taxes; it does not compound them. What is in fact being claimed by those who advance this argument is that the federal government should automatically reduce its share of the personal income tax whenever a province wants more revenue—a completely unacceptable proposition.

Moreover, even if the federal and provincial governments each had their own personal income tax rate schedule, if both imposed taxes on the same base some would still try to persuade the ill-informed that this was a form of "double" taxation and, in some unspecified sense, reprehensible. As long as two governments occupy the same tax field, blame for high taxes will be laid by the one on the other.

Some individuals are probably unaware that the federal government is collecting both federal and provincial personal income taxes for all



provinces except Quebec. This ignorance is unlikely to be dispelled by the adoption of two separate rate schedules on a joint federal-provincial personal income tax return on a common form. Those who are unwilling to read the present tax forms are unlikely to understand the method unless there are two entirely separate returns which are filed at different places at different times. A programme of public education would appear to be the answer, not a duplication of effort and greater complexity.

There is, however, one argument for separate provincial personal rate schedules that cannot be dismissed. A province may seek a rate schedule with more or less progressiveness built into it than the rate schedule adopted by the federal government if the collective social attitudes of the residents of that province differ from those prevalent in other parts of Canada. There may then be no alternative to a separate provincial personal income tax rate schedule.

Separate provincial rate schedules, while more cumbersome and complex, would not create major technical problems under the system we propose if one condition were met. To prevent tax avoidance or deferment by upper income shareholders, the top marginal rate of tax levied by a province when added to the top federal marginal rate, should not exceed 55 per cent—the total corporation tax rate plus 5 per cent. This is not a stringent limitation because, as stated earlier in the Report, a province that wished to adopt a more highly progressive tax system might supplement the personal income tax with a net worth tax on those resident individuals with substantial assets.

#### Abolition of Death Taxes

We propose that all gifts, whether inter vivos gifts or inheritances, should be taxed as income, except gifts between members of a family unit. Accordingly, if our recommendations were accepted by the federal government

and the same base was adopted by provincial governments, the death taxes now imposed by the federal government and the governments of Quebec, Ontario and British Columbia would be redundant. Acceptance of our recommendations in this area would mean an enormous simplification for the taxpayer and would eliminate the present duplication of administrative effort. We are convinced that there would be a great improvement in equity and a closing of the loopholes that now riddle the system.

If the provinces accepted an income tax base that included gifts and inheritances they would, of course, share in the revenue from this component of income in the same way as they share in the revenue from income generally. It is difficult to estimate what the provincial revenue from this particular source would be under the proposed system compared with what it is under the present system. We cannot determine precisely how much would be gained by closing existing loopholes and by eliminating the present exemptions. We can only assume what the allocation of inter-family gifts would be. However, based on the estimates shown in Chapter 35, we are satisfied that taxing gifts in the manner we recommend would raise more revenue than all of the present federal and provincial death taxes. The provinces, in effect, now get 75 per cent of the revenue from this source through abatement of the estate tax or in the form of grants from the federal government, or a combination of these methods. It should not be difficult for the federal government to devise a system that would guarantee the provinces no revenue loss if they discontinued their death taxes.

#### SALES TAXES

In Volume 5 we reviewed the advantages and disadvantages of sales taxes of all types. We concluded that a retail sales tax was vastly superior to a manufacturer's sales tax and recommended that the federal government replace the present manufacturer's tax with a tax at the retail level. With eight of the ten provinces already levying retail sales taxes, our recommendation obviously has implications for federal-provincial relations. At the beginning of this chapter we set forth what we believe to be important objectives with regard to taxes in fields of mutual concern to the federal

government and the provinces. These objectives—a common base, co-ordinated rates and collection arrangements—are relevant if our recommendation that the federal government move its sales tax to the retail level is accepted.

#### The Scope or Coverage of the Tax

The overall benefit to be derived from moving the federal sales tax base to the retail level would clearly be limited unless the federal sales tax system was co-ordinated with the existing provincial structures. In fact, a separate federal retail sales tax that was not co-ordinated with the existing provincial sales taxes would burden retailers with a multiplicity of rates, exemptions, calculations, remittances and the like. One of the important arguments supporting a federal shift to the retail level is the prospect of eliminating the present duplication of sales tax administrations at the federal and provincial levels. Essential to the attainment of this objective is the adoption by the federal government and the provinces of a common retail sales tax base.

We have outlined in broad terms in Chapter 29 our views on the scope or coverage of a sales tax. It is obvious that the introduction of a composite federal-provincial sales tax at the retail level injects an important additional consideration into the tax coverage that we have proposed, namely, the need to equate the federal and provincial retail sales tax bases. We realize that the determination of a common base will not be easy, particularly where substantial revenues are involved; we also recognize that the penalty for failing to reach agreement could be severe, for taxpayer and administrator alike.

We are satisfied, however, that with good will on both sides it will be possible for the federal and provincial governments to reach an agreement on a common base. To this end we hope that both levels of government will give careful consideration to our recommendations with respect to the scope of a retail sales tax. We are convinced that within the broad guidelines we



have established it will be possible to develop a common base that is equitable, administratively feasible and consistent with the desire for an adequate rate of economic growth.

#### "Direct" or "Indirect" Retail Sales Tax

The form of retail sales tax used by the provinces is conditioned by the provisions of the British North America Act. Whereas the federal government can levy virtually any form of tax, 7/ the provincial governments are limited to "Direct Taxation within the Province in order to the Raising of a Revenue for Provincial Purposes" 8/. Accordingly, although the provinces do not have the legislative competence to impose a sales tax on retailers, that is, an "indirect" tax in that it would be passed on to the customers, they may impose a sales tax on consumers and require retailers to act as collection agents 9/. By this means they are able to use the basic administrative mechanics of a tax which is "indirect" in terms of licensing and collecting tax from vendors and, at the same time, the tax is technically levied in a "direct" form, that is, it is demanded from the persons who it is intended should pay it, namely, the consumers or users.

The proposal for a composite federal-provincial retail sales tax prompts two questions:

1. What are the respective merits of the direct and indirect forms?
2. What are the constitutional limitations on the enactment and administration of each of the two forms of tax?

The indirect form of tax is not without technical problems. Goods purchased outside a province and brought into the province for consumption automatically fall within the scope of a direct sales tax; if an indirect tax were imposed on vendors it would be necessary to allocate the sales among provinces on the basis of place of shipment or place of destination of the goods or on some other basis. It would probably be advisable under an

indirect tax to require retailers to pay tax to the province to which the goods were destined. Another difficulty with the indirect form arises from the fact that some dealers sell many low-priced items. Should they absorb the amount of the tax or raise their prices?

On balance, we believe that the reduction in compliance costs for most dealers under an indirect retail sales tax outweighs these disadvantages. Under an indirect sales tax, the higher the rate of tax the less the problem for the dealer in items that retail for small amounts. At the combined rate of federal and provincial taxes that probably would prevail, the problem might not be considered significant. If it were judged important, it would be possible to allow retailers an option to remit tax on individual sales of specified minimum taxable amounts. Some retailers in some provinces are now collecting tax on a destination basis. The adoption of an indirect tax, with the requirement that goods being shipped out of the province be taxed at the rate applicable in the province of destination, to which the proceeds would be remitted, should not involve much more complexity.

#### Constitutional Considerations

It is a well-established rule of Canadian constitutional law that neither the federal government nor a provincial government can delegate to the other a legislative authority given exclusively to it under the British North America Act. Although the Act is silent on the subject of delegation of powers, it has been held by the Supreme Court of Canada in Attorney-General of Nova Scotia et al. v. Attorney-General of Canada 10/ that it is unconstitutional for Canada or a province to delegate any of its powers to the other.

The rule prohibiting delegation of power has no application where Parliament or a provincial legislature incorporates by reference into its valid legislation the valid enactments of the other.

Thus, it would be unconstitutional for Parliament to delegate to a province the power to enact an indirect retail sales tax. However, this

limitation would in no way affect the power of Parliament to grant to a provincial body the administrative function arising out of a statute which Parliament had passed. It would therefore be possible for Parliament to agree with a provincial legislature on the administration of an indirect sales tax.

In terms of possible structure, and disregarding constitutional considerations, any joint federal-provincial indirect retail sales tax might be enacted by:

1. The federal government, which would pay part of the revenue raised to the province.
2. The federal and provincial governments, each of which would retain the revenue raised under its own legislation 11/.
3. The provincial governments, which would pay part of the revenue to the federal government.

Regardless of which government enacted this legislation, it could be administered by:

- a) The federal government.
- b) The federal and provincial governments jointly or separately.
- c) The provincial governments.

There are therefore nine possible schemes, being combinations of 1, 2 or 3, depending on who enacts the legislation, and (a), (b) or (c), depending on who administers the legislation.

Having regard to the constitutional principles previously enunciated:

Schemes 1 - (a), (b) and (c) would be constitutionally valid.

Schemes 2 - (a), (b) and (c) would be valid only to the extent of the federal legislation.



Schemes 3 - (a), (b) and (c) would be constitutionally invalid.

To make the alternatives embodying 2 and 3 valid, it would be necessary to amend the British North America Act to allow provinces to levy an indirect sales tax. In addition, to make alternative 3 valid, it might be necessary to have an enabling section which would allow provinces to levy tax and give part of it to the federal government, since the words of the present section 92(2) "to the Raising of a Revenue for Provincial Purposes" could be construed to preclude provincial governments from levying a tax and giving the revenue to the federal government.

Although it would be technically possible for the federal government to levy an indirect type of retail sales tax and the provinces to continue with a direct form of retail sales tax with identical coverage, this would be undesirable. One of the advantages of moving the federal sales tax to the retail level is the possibility of reducing duplication of effort. It would be regrettable if retailers had to keep two sets of records for no reason other than to satisfy the requirements of constitutional law 12/. On the other hand, we dislike the idea of raising provincial revenues by means of an indirect retail sales tax levied under a federal statute in order to comply with the constitution.

If the sales tax is to be a joint tax with a common base, we think it would be misleading to the public, and probably unsatisfactory to both levels of government, to depend solely on federal legislation. We would therefore suggest that, if the provinces and the federal government can agree on a common retail sales tax base, the British North America Act should be amended to permit the provinces to levy indirect retail sales taxes on this agreed base. The risks involved in extending provincial taxing powers in this way are, we believe, minuscule. Much greater dangers of tax barriers and inter-provincial tax competition are associated with the corporation income tax, which the provinces are now competent to impose, than would arise in connection with provincial indirect retail sales taxes.

## Interprovincial Transactions

In principle, under the provincial retail sales taxes, taxable goods sold in one province and delivered or taken by customers to another are subject to the sales tax of the importing province. They are exempted from the tax levied by the exporting province only when physical delivery to the customer is made in the importing province. In practice, because there is no machinery for dealing with interprovincial movement of goods, provincial sales taxes are not paid in respect of some transactions of this nature. On the other hand, because the exemption afforded by a province on goods exported to another province is a limited one, certain other transactions are ultimately subjected to sales taxes in two provinces.

The loss of revenue involved in the first situation is minimized by a number of factors. For one thing, a large proportion of imports is delivered to business firms, for the majority of which it is routine both to show the tax liability in their accounts and to remit the tax when due. For another, all motor vehicles imported into a given province must, within a limited period, be registered in that province. In addition, the large mail order houses bill their customers for the appropriate provincial sales tax and, when it is collected, remit it to the province in question. Finally, some firms having various provincial offices are registered with the respective provinces and remit the appropriate taxes. In 1963, Quebec enacted a provision requiring all firms soliciting business in that province to register with the provincial taxing authority. If this legislation is held by the courts to be constitutionally valid, it may become general for all provinces.

On the other hand, certain commodities, notably motor vehicles which require registration in the province of residence of the owner, and goods imported by business firms, may attract the sales taxes of two (and, in rare cases, more) provinces when purchased in one and exported to another. The amounts involved are, for practical purposes, indeterminate, but as Professor Due puts it, "The amount of potential double taxation...is substantial" 13/.

Under a system of indirect retail sales taxes imposed by the provinces, goods would be taxed in the exporting province and would not be subject to tax in the importing province, in the absence of provisions to the contrary. Although substantial differences in provincial rates of tax would lead residents of provinces with high rates to import goods from provinces with low rates, on most interprovincial shipments the advantages to be derived from differences in rates would not be as great as the advantages that can now be had by residents of one province buying goods in another province free of tax and evading the tax payable to the province of residence when the goods are imported. Among most of the provinces the differences in sales tax rates would be much smaller than the difference between a zero rate and the rate of tax imposed in the province of residence. Problems would continue to exist, however, if the two provinces that do not impose retail sales tax continued not to do so. In addition, provinces that were large exporters of goods to consumers would have increased revenues relative to provinces that relied more heavily on imported goods.

While there is no simple solution to this problem, we would suggest that each retailer in each province be required to pay tax to the province of destination on sales to customers in other provinces. If Manitoba and Alberta refrained from imposing provincial sales taxes, the federal government might, by appropriate legislation, attempt to oblige retailers in these provinces to collect tax for other provinces on goods destined for those other provinces.

#### Administration of a Federal-Provincial Retail Sales Tax

Separate provincial retail sales tax administrations are to be found in all provinces except Manitoba and Alberta. They have all operated long enough to warrant the belief that they are technically adequate and have some degree of public acceptance. Any federal retail sales tax machinery would require a complete overhaul of the existing federal system which applies to an entirely different distributive level and is concerned with economic situations of a



different kind. These circumstances suggest that provincial administration would be preferable to federal administration. We recommend that this objective be sought by the federal government.

We reached this conclusion not unmindful of the problems that would be involved in trying to weld the various provincial administrations into a collection machine that was consistent from province to province. The present provincial administrations vary so widely among themselves with respect to such things as organizational structure, staff qualifications, enforcement practices and the frequency and nature of audits of licensed vendors, that it would be difficult to form a homogeneous nation-wide system. In order to achieve a structure that was mutually acceptable to the provinces and the federal government, a great deal of reconstruction would be necessary.

If, as we would prefer, the federal-provincial sales tax was administered by the provinces, it would be necessary to establish procedures whereby the federal government could be satisfied that federal revenues were being fully collected by the provinces. Federal audits should be of assistance to the provincial administrators because, with uniform standards across the country, they would enable each province to assess its performance in an objective manner.

#### Rates of Tax

As we envisage the ultimate system, the federal and provincial governments would agree on a common retail sales tax base. The British North America Act would be amended to allow the provinces to impose an indirect type of retail tax. The provinces would adopt the new base, imposing whatever rates they wished to apply. After the system had functioned for a time and the major administrative problems with the new base had been worked out by the provinces and the federal government, the federal government would terminate its manufacturer's sales tax and impose a tax on the common base. It seems probable that, at least to begin with, the federal rate would be

the same in all provinces. In Manitoba and Alberta the tax would be administered by the federal government if these provincial governments did not impose a retail sales tax before the inception of the federal retail sales tax.

We have estimated elsewhere in our Report that the federal government could raise approximately the same revenues from a sales tax imposed at the retail level at a rate of 7 per cent to 8 per cent, given the base we recommend, as it now raises under the present manufacturer's tax with a rate of 11 per cent. If the federal government wished to make more sales tax room available for the provinces, to compensate the provinces for exclusive federal occupancy of the corporation tax field for example, after moving to the retail level the federal government could reduce the federal rate of sales tax so that the provinces could increase their rates without increasing the overall rate. Thereafter, the federal government could make more tax room available to the provinces simply by reducing its rate of retail sales tax 14/. The provinces would be free to raise their rates by more or less than the amounts by which the federal government reduced its rates and could change their rates at any time.

We feel that the attitude of the provinces toward our proposal would depend to a very large extent on:

1. How much additional revenue they required and when.
2. How difficult they think it would be for them to raise their rates when the combined rate was, say, 13 per cent.
3. The extent to which the federal government would be willing to make tax room available with respect to sales taxes.

These are all questions outside our purview, but we should like to make a few observations we think pertinent.

With a combined sales tax rate of about 13 per cent, it might be argued that the retail sales tax field would be pre-empted, in the sense that the avoidance and evasion which would result from higher rates would preclude the provinces from raising their rates. We doubt very much that there is a particular rate beyond which the retail sales tax system would break down, so that we do not think this point of view has much substance. Nevertheless, we acknowledge the obvious: there can be no doubt that there would be more problems in raising the rate from 13 per cent to 15 per cent than from 5 per cent to 7 per cent.

The basic issue here is not whether the sales tax rate could be increased but whether it should be increased. As we said in our earlier discussion of the tax mix, we are opposed to increasing the relative weight of indirect taxes. There is no reason to believe that increasing the weight of sales taxes would materially improve Canada's international competitive position. We doubt that a greater reliance on sales taxes would have a significant effect on the rate of saving and, hence, on the rate of growth. While the exemption from sales tax of the necessities of life or the provision of credits for sales tax against income tax liabilities can convert a sales tax into a reasonably equitable taxing instrument, we do not believe that sales taxes can achieve the same degree of equity that income taxes can achieve. All in all, we are convinced that, in the future, Canada should gradually try to reduce, not increase, the relative weight of sales taxes. This can be achieved by not increasing the total of federal and provincial sales tax rates and by allowing the growth in income tax revenues over time to reduce gradually the relative importance of sales tax revenues. If the provinces should require more revenues, we believe that, on the basis of all of the information available to us, increases in provincial personal income tax rates would be preferable to increases in sales tax rates.

If sales taxes are less desirable taxes than income taxes, as we suggest, why should the provinces be led to rely more heavily on sales taxes than they



do at present? First, as we discussed in Chapter 8, we acknowledge that in a system with three levels of government it is desirable that each level have a tax source over which it has primary control in order to maintain fiscal responsibility. Secondly, we are of the opinion that, having regard to the sales tax rates that are likely to be in effect in Canada in the foreseeable future, changes in sales tax rates cannot be used effectively to stabilize the economy, except to impose special excise taxes on goods in particularly short supply in inflationary periods. On the other hand, changes in personal income tax rates are a potentially important stabilizing tool. This means that, at least until a joint stabilization strategy has been developed, the federal government must have manoeuvring room with respect to personal income tax changes. This in turn means that the federal proportion of personal income tax revenues should not be further reduced. If the federal government is going to make more tax room available to the provinces, it is important that some source other than personal income taxes be ceded. Thirdly, we would like to see the federal government obtain exclusive jurisdiction over the corporation income tax, and equivalent revenues would have to be offered in exchange. Fourthly, although we have no strong evidence on the subject, we think that of the two taxes, the sales tax is more efficiently administered at the provincial level than the income tax. It does not seem unreasonable to suggest that the provincial revenues should depend heavily on the tax that the provinces can most effectively administer.

#### CONCLUSIONS AND RECOMMENDATIONS

1. While consultation with the provinces should occur, the federal government should continue to play a predominant role in income tax matters in order that it may:
  - a) Pursue an effective stabilization policy.
  - b) Ensure that the income tax does not become a device through which the stronger provinces take advantage of the weaker.

- c) Ensure that redistributive objectives are recognized.
- 2. The federal and provincial governments should seek common bases for income and sales taxes. Obviously we hope that these common bases would embody our major recommendations.

#### PERSONAL AND CORPORATION INCOME TAXES

- 3. The federal government should seek to become the collection agent for all personal income taxes. Administrative policy would be established mutually and the provinces would have full access to all information necessary to ensure that their interests were being safeguarded.
- 4. The recommended integration of personal and corporation income taxes would be greatly facilitated if the federal government obtained exclusive use of the corporation income tax by providing the provinces with a share of the corporation income tax revenue or, alternatively, with retail sales tax room. The federal government would give resident shareholders full credit for the corporation income tax.
- 5. If the provinces would not agree to withdraw from the corporation income tax field, the federal government should provide resident shareholders with full credit for federal corporation income tax and a standard rate of provincial corporation income tax.
- 6. Federal and provincial income tax rates should be harmonized. The simplest course would be to continue the present system of federal abatements, with the provinces levying personal income taxes as a percentage of the federal tax. An upper limit to the provincial rate would be necessary to prevent postponement of personal income tax through the retention of corporate earnings. To abandon the present

system in order to forestall fallacious "double" taxation arguments or to make clear to the taxpayer what is being collected, and for whom, would add needless complexities.

7. Provinces may wish to impose a more progressive or a less progressive tax system than the federal rate structure would achieve. This would necessitate separate provincial rate structures. Although more cumbersome, this would pose no insoluble technical problems if the combined federal and provincial top marginal personal rates did not greatly exceed 50 per cent.

#### RETAIL SALES TAX

8. The federal government should seek to establish with the provinces a joint indirect retail sales tax that would replace the manufacturer's sales tax and the present provincial direct retail sales taxes.
9. The constitution should be amended so as to allow the provinces to levy an indirect retail sales tax on a common base agreed upon by all governments.
10. This base should take into account our recommendations in Chapter 29 on the scope and coverage of the retail sales tax.
11. If it can be arranged, this composite sales tax should be administered by the provinces under a mutually determined policy with guarantees that would protect the federal revenue.
12. Should the federal government wish to make more tax room available to the provinces in the future, we recommend that the federal rate of tax on this common sales tax base should be reduced.
13. Each province should be free to set its own rate of tax on the common sales tax base and could do so without damage to the system.



## REFERENCES

- 1/ See also James Lynn, Federal-Provincial Fiscal Relations, a study published by the Commission.
- 2/ Statutes of Canada, 1960-61, Chapter 58.
- 3/ Income Tax Regulations, Part XXVI.
- 4/ Ibid., Part IV.
- 5/ As we state later, we would prefer that the federal government seek exclusive use of the corporation income tax. However, if this was not acceptable to the provinces, federal collection of provincial corporation income taxes would be desirable.
- 6/ The Quebec personal income tax rates are virtually a constant proportion of the federal rates.
- 7/ British North America Act, section 91(3).
- 8/ Ibid., section 92(2).
- 9/ See Cairns Construction Ltd. v. The Government of Saskatchewan, [1960] S.C.R. 619.
- 10/ [1951] S.C.R. 31.
- 11/ This, in effect, is the present legislative scheme regarding the personal income tax.
- 12/ As is indicated above, under an indirect form of retail sales tax, it might be considered necessary to require retailers to keep track of sales by province of destination and allow retailers with a high volume of low value items to pay tax on the direct basis. An indirect form of tax would not necessarily mean that all record keeping would be eliminated.

13/ J. F. Due, Provincial Sales Taxes, Toronto: Canadian Tax Foundation,  
1964, p. 178.

14/ This is a conditional statement of fact and neither a prediction nor  
a recommendation.





ASSUMPTIONS UNDERLYING OUR ESTIMATES OF THE REVENUE YIELD  
AND INCIDENCE OF CURRENT AND PROPOSED DIRECT TAXES

The notes set out in this appendix provide brief explanations of how the various estimates presented in Chapters 35 and 36 were determined. As such, they constitute a convenient summary of the assumptions used in estimating what the revenue yield and incidence of the recommended comprehensive-base income tax would have been in 1964. Further details may be found in certain of the studies published by the Commission and referred to in these notes.

With some exceptions, the notes are numbered in the order in which they are referred to in the tables in Chapter 35.

RECONCILIATION OF THE ACTUAL AMOUNT OF PERSONAL INCOME TAX  
REVENUE FOR 1964 TO THE REVENUE THAT WOULD HAVE RESULTED  
IN 1964 UNDER CURRENT (1966) TAX LAW (TABLE 35-2)

1. The 1964 federal income tax accruals shown are preliminary figures for 1966 Taxation Statistics, Part One (Individual Tax Statistics for 1964), obtained from the 1964 tax return sample supplied to us by the Department of National Revenue. This sample did not consist of the actual income tax returns but rather of data which were extracted from the tax returns by the Taxation Division. No taxpayer identification was divulged. The sample thus consists of unidentified data from each of 417,000 tax returns from which the tables to be published are aggregated. Its selection is described in 1966 Taxation Statistics, Part One, p. 97. These figures exclude taxes paid by members of the armed forces as well as the effects of late collections and reassessments.
2. Personal income tax abated to the provinces was calculated as 18 per cent of the total personal income tax before abatement, less an estimate of the tax on income arising in the Yukon Territory, the Northwest Territories and outside Canada. The estimated abatement of \$433 million to all the provinces for 1964 compares with a total of \$336 million in total provincial income taxes, including amounts in excess of the abatement, accrued in 1964 for provinces other than Quebec.

3. The 1964 personal income tax base under 1964 tax law was obtained from the 1964 tax return sample. It represents the difference between the \$14,172 million of taxable income assessed to taxpayers and the \$861 million excess of exemptions and deductions over total income assessed on non-taxable returns. This figure does not take into account any estimate of the excess of exemptions and deductions over total income assessed to persons not filing returns.
4. The estimate of the effect of paying the old age security pension and eliminating the \$500 old age exemption to persons between the ages of 65 and 70 who filed tax returns in 1964 was based on data obtained from the source cited in Note 1. More than 170,000 persons in this age bracket filed tax returns in 1964.
5. The estimate of deductible Canada Pension Plan premiums was based on calculations for the average taxpayer in each of 19,370 classes into which the 417,000 tax returns in the sample were aggregated. The classification of returns is described in Appendix B to this Volume. It was assumed that all wages of taxpayers in 1964 were fully subject to assessment for Canada Pension Plan contributions. Self-employed persons paying less than maximum contributions on employment income were assumed to pay both employer and employee premiums on income from self-employment to the extent necessary to bring premiums paid by and for the taxpayer up to the maximum. The detailed calculations are described in computer programmes in J. Bossons, A General Income Tax Analyzer, a study published by the Commission and hereinafter referred to as Analyzer.
6. In calculating the tax on the revised 1964 personal income tax base, adjustments were made for changes enacted between 1964 and 1966 in the scope of the personal income tax base and 1964 tax rates were used. The tax was aggregated from calculations for average taxpayers in each of 19,370 classes as described in J. Bossons, Analyzer. The tax includes old age security tax as well as personal income tax before abatements to the provinces. The \$2,779 million of tax on the revised base is \$36 million less than what was actually accrued in 1964 on the unadjusted tax base.

7. The revenue loss of \$103 million resulting from changes in tax rates is an estimate of the effect of the 20 per cent reduction, up to a maximum of \$20, in personal income tax before abatement to the provinces enacted in 1966, and is based on calculations cited in Note 6.

8. "Sample averaging errors" consist of an estimate of the effect of calculating the taxes accrued in 1964 from averages for each of the 19,370 classes into which the 1964 tax return sample was classified, rather than calculating the tax accrued on each tax return in the sample individually. The estimate is based on calculations described in the listing of sub-routine SUMDAT in J. Bossons, Analyzer.

CHANGES IN THE 1964 CORPORATION  
TAX BASE (TABLE 35-4)

9. The 1964 corporation tax base for companies taxable under the current tax law was obtained from preliminary figures for Table 1 of 1966 Taxation Statistics, Part Two, supplied to us by the Department of National Revenue.

10. The estimate of the percentage depletion allowances deducted by taxpayers with income from mining and petroleum in 1964 was obtained from preliminary figures for Table 4 of 1966 Taxation Statistics, Part Two, supplied to us by the Department of National Revenue.

11. Unpublished figures supplied by the Department of National Revenue indicate that in recent years the amounts deducted under the three-year exemption for new mines have been approximately the same as the total depletion allowance claimed on income from mining and petroleum operations.

12. Our estimate of the effect of eliminating special provisions defining the taxable income of life insurance companies was based upon figures supplied by the Department of Insurance. Chapter 24 contains further details of the proposals that affect this estimate and of the composition of this change in the tax base. Since the imposition of the special branch tax would be extended to the income of non-resident life insurance companies



and since the taxation of the foreign source income of Canadian companies should provide more revenue than the existing taxes on all life insurance companies, we have included in this estimate all the income which would be taxable under our proposals from the selling of life insurance in Canada. This corporate income is distributed approximately as follows: federal companies—\$100 million; non-resident companies—\$40 million; provincial companies and fraternal benefit societies—\$10 million.

13. Our estimate of the effect of other changes in the definition of the income of financial institutions was based upon information supplied by the Department of Insurance, the Inspector General of Banks and the Department of National Revenue. This amount does not include the transitional adjustments that would be required to reduce the balances of the reserves for tax purposes as at the effective date of the legislation implementing our proposals. An estimate of the latter figure is included in the amounts set out for the transitional period in Chapter 35.

14. The effect of including capital gains and losses realized by corporations in the corporation tax base was estimated on the basis of United States data on capital gains and losses reported by corporations in different industries. Our estimate of a \$200 million increase in the tax base represents less than 5 per cent of total corporate profits before tax and excluding such gains, compared to the United States average of more than 8 per cent. Some details of how this estimate was derived are presented in G. R. Conway, The Taxation of Capital Gains, a study published by the Commission. This amount reflects the proposal that all so-called "nothings" should become deductible.

15. An estimate was made by the Commission staff of the minimum amount that would be added to the tax base from, among other things, a reduction of tax avoidance. This estimate took into account our proposals concerning foreign source income, increased reporting requirements, increased audit work by the tax authorities and elimination of other avenues for tax avoidance and tax minimization.

16. An estimate was made by the Commission staff of the effect of the recommended 100 per cent capital cost allowance to be allowed to companies which qualify as new and small businesses as defined in Chapter 22. An acceleration of capital cost allowances should not in principle affect the tax base in the long run, as it would represent only a more rapid write-off of amounts that would be deductible in any event. However, as it could be expected that new and small companies would continue to be formed at an increasing rate, an acceleration of write-offs would in fact reduce tax revenues, the amount of loss being dependent upon the increase in qualified capital expenditures over the amount that qualified in the prior year.

17. The effect of extending the carry-forward period applicable to corporate losses was estimated by the Commission staff. This amount reflects only the business losses of corporations. An estimate of capital losses was deducted in arriving at the amount of net capital gains as set out in Note 14. This estimate was based on figures for total losses and for losses deducted as reported in Taxation Statistics for the taxation years 1950 and 1964.

CORPORATE SOURCE INCOME ATTRIBUTABLE TO RESIDENT  
INDIVIDUALS IN 1964 (TABLE 35-5)

18. Estimates presented in Table 50, National Accounts Income and Expenditure, 1964, indicate that dividends paid to residents of Canada who were individuals, trustees of Registered Retirement Income Plans and charitable organizations (hereinafter referred to as "residents") were 47 per cent of the total dividends paid to residents and non-residents in 1964. The \$610 million shown for 1964 in the National Accounts for dividends paid to residents exceeds the sum of the \$451 million that was reported on the tax returns of individuals and the \$50 million that we estimate was received by charitable organizations and those financial intermediaries, primarily pension funds, that are classed as persons in the National Accounts. We assume the difference to be primarily unreported dividend income; this compares to the approximately 10 per cent of total dividend income estimated to be unreported in 1958 in the United States by D. M. Holland, Dividends

Under the Income Tax, Princeton: Princeton University Press, 1962. In the 1965 edition of the National Accounts the figures for dividend payments to residents and non-residents in 1964 were revised. The estimate of dividends paid to Canadian persons was increased to \$677 million and the percentage of these dividends to total dividends became 49 per cent. The procedure we have followed for grossing-up the actual dividends reported by individuals filing tax returns to a figure equal to the portion of corporation profits attributable to resident individuals means that any currently unreported dividends from resident companies are included in our estimates of the comprehensive tax base. This procedure is discussed in Note 28.

We have assumed that the percentage of total corporate source income attributable to residents was 47 per cent. That is, we have assumed that average pay-out ratios were approximately the same for resident and non-resident-owned companies. We reviewed data supplied to us by the Department of National Revenue for large private companies and the published financial statements of several large public companies. For all these companies we obtained estimates of the proportion of foreign ownership from reports submitted under the Corporations and Labour Unions Returns Act, S.C. 1962, Chapter 26. Pay-out ratios varied greatly among companies, and in the aggregate the pay-out ratio was slightly higher for the portion of profits attributable to non-residents. However, we were not able to obtain reliable information on dividend pay-out rates for small and medium-sized companies. Because there was not a very great difference between the pay-out ratios for the large companies owned by residents and for the large companies owned by non-residents that were analyzed, we estimated that the proportion of profits attributable to non-residents was the same as the proportion of dividends paid to them.

We also reviewed the information on ownership ratios published in the Report for 1962 submitted under the Corporations and Labour Unions Returns Act and in The Canadian Balance of International Payments, 1961 and 1962 and



International Investment Position. As these publications concern the year 1962 and not 1964; as the profit figures they show are not readily reconcilable to the amounts reported in Taxation Statistics, Part Two; as we encountered a number of other difficulties in attempting to use the data presented in these publications, and as in any event the results reported therein do not differ greatly from the percentage based upon estimated aggregate dividend payments, we have used the figure of 47 per cent as being the portion of the corporation tax base attributable to residents.

19. The estimate discussed in Note 18 of the portion of the current corporation tax base attributable to residents represents an average for all industries. Because of inter-industry differences in ownership fractions, it is not applicable to the net increases in the corporation tax base that would be brought about by our proposals. As a result we have used estimates of the percentages of ownership by non-residents for each industry affected by each major item of change in the base in order to give appropriate weight to each change in the base in arriving at the aggregate amount attributable to residents and non-residents respectively. The estimates that we have used for the fraction of the non-resident interest in the tax changes are as follows: mining and petroleum, 67 per cent; life insurance companies, 40 per cent; manufacturing, 54 per cent; and others, an average of over 20 per cent. Because of the concentration of non-resident ownership in larger companies, a relatively small proportion of base changes resulting from the effects of extended loss carry-over provisions and of accelerated capital cost allowances for new and small businesses was assumed to be attributable to non-residents. Moreover, we have adjusted our estimates to reflect the impact of our proposals on a number of large companies in which the degree of foreign ownership differed from the industry average.

20. Our allowance of \$100 million for the delay in the attribution of part of the corporation tax base to resident individuals is primarily a result of the deferment of tax on corporate income paid or attributable to Registered Retirement Income Plans. In 1964 the Canadian dividends received by intermediaries who

would generally not be taxable under our recommendations—the trustees of Registered Retirement Income Plans and charitable and certain other organizations as defined in Chapter 20—totalled almost \$50 million. However, our proposals would not as a consequence have reduced the tax base by over \$200 million, the before-tax corporation income underlying these dividends if one assumes an average pay-out ratio of 50 per cent, because we have proposed that individuals receiving benefits from Registered Retirement Income Plans or charitable or other organizations should include such benefits in income. The reduction in the tax base would result because the growth in Registered Retirement Income Plans would mean that for many years benefits paid would be less than the amounts received by the plans. In addition, many of the benefits disbursed by charitable organizations would be received by individuals with low incomes and therefore would not be subject to tax. We therefore arbitrarily assumed that, at least for a number of years, the collection of tax would be deferred on an amount equivalent to half of this corporate source income. It was assumed that the balance of the corporate source income underlying the dividends paid to these tax-exempt organizations would in effect "flow through" to individual beneficiaries who received payments from these intermediaries. This portion of the corporate source income would thus be taxable immediately.

21. As we stated in Chapter 19 and in Appendix M to Volume 4, net capital gains realized by resident individuals on shares of corporations were assumed to be equal to dividends of Canadian companies reported by individuals filing income tax returns. Because capital gains due to retentions would already be brought into the comprehensive tax base through our integration proposals, net capital gains or "goodwill" gains are defined as total gains less changes in surplus as reported in published financial statements.

Data on the relative importance of dividends, retentions, and goodwill gains for 64 Canadian companies accounting for roughly 25 per cent of total taxable Canadian corporate income in 1964 are presented in J. Bossons,

Rates of Return on Canadian Common Stocks: Dividends, Retentions, and Goodwill Gains, a study published by the Commission. For 26 companies not in the resource industries, for which data covering a period of 10 years were collected, the average rate of return over the years 1955 to 1964, weighted both by size and by degree of Canadian ownership, was 12 per cent. Of this total return, 32 per cent was accounted for by dividends and 23 per cent by retentions; the remaining 45 per cent resulted from accrued goodwill gains. For 11 resource companies, the average rate of return over this period was 11 per cent; dividends accounted for 34 per cent of the total return and accrued goodwill gains accounted for 45 per cent. In both cases, capital gains resulting from the retention of earnings not now taxed at the corporate level have been included in the retention figure because most of such gains would be brought into the expanded corporation tax base under our proposals. The revenue implications of taxing this income have already been included in Table 35-4. However, some reported retentions would still be untaxed at the corporate level, and to ignore them would to some extent under-estimate taxable goodwill gains. Hence, an amount was included to reflect this kind of income, as we indicate in Note 22.

Even though the period 1955 to 1964 included several years with low total goodwill gains or even goodwill losses for the 37 companies analyzed, the goodwill gains for all 37 companies combined over these 10 years averaged \$569 million a year, of which \$321 million was attributable to residents. Our estimate of taxable capital gains of \$451 million on all corporate stock owned by Canadian residents is thus only 40 per cent larger than the average goodwill gains attributable to residents from these 37 stocks alone.

For these 37 companies, goodwill gains attributable to residents were roughly 130 per cent of dividends for the period 1955 to 1964. Data were collected over a longer period for 21 of these companies; on the average, goodwill gains attributable to residents were 120 per cent of dividends paid to residents for these companies between 1945 and 1964. Data were also



collected for an additional 27 companies for the 4 years 1961 to 1964; for these companies the ratio of goodwill gains attributable to residents to dividends paid to residents was more than 35 per cent higher than the value of the same ratio for 1961 to 1964 for the 37 companies for which a longer period was covered. All this and other data presented in J. Bossons, Rates of Return on Canadian Common Stocks indicate that the rates of goodwill gains to dividends is not overly sensitive to the type of company or length of period analyzed; in virtually all cases of large firms owned by residents, goodwill gains exceed dividends on shares.

We appreciate that the time period employed for this study may be part of a period—the postwar years—when average increases in share prices were higher than could be expected if one used a much longer time period for analysis, for example, a period which included the depression of the 1930's. However, net capital gains may well be a smaller multiple of dividends for many smaller companies than the above sample would indicate. On the other hand, we have not analyzed a number of rapidly growing companies of moderate size which have high capital gains in relation to dividends. In any case, our assumption that realized gains equal reported dividends produces an amount that is substantially less than the figure that would result if the above percentages were applied to the total dividends actually received or attributable to resident individuals.

Because our estimates are of long-term yields, we have assumed that realized and accrued capital gains will be roughly equal, particularly with respect to gains on stocks of large, widely traded firms. Additional discussion of the relationship between accrued and realized gains based upon United States data appears in G. R. Conway, The Taxation of Capital Gains, a study published by the Commission. Our estimates reflect our recommendation that transfers at death should be deemed to be dispositions for tax purposes and that losses at the corporate level should be eligible for an unlimited carry-forward.

In order to allow a margin for error, we have based our estimate of taxable gains on an assumption that goodwill gains realized by individuals are no more than equal to reported dividends. Because reported dividends are less than actual dividends received by resident individuals, and because we have not included dividends received by tax-exempt intermediaries (see Note 20) in the amount to be "matched" by goodwill gains, this procedure means that we are in fact estimating goodwill gains to be substantially less than dividends.

22. It was assumed in allocating the corporation tax base and tax that 95 per cent of dividends received would carry the full credit for corporation tax paid on behalf of resident shareholders. The remaining \$22 million of dividends received was assumed to be paid out of surplus reported by corporations that was not surplus for tax purposes, that is, that was "income" that had not yet been taxed. This difference would arise primarily because the depreciation recorded in the accounts of many companies would be less than the capital cost allowance claimed for tax purposes. Our proposals would mean that this would be particularly applicable to mining and petroleum companies. Once assets were fully depreciated, the aggregate income reported and the aggregate income taxed over the intervening years would be equal, but in the interim, income reported for corporate purposes would generally exceed the income as determined for tax purposes. As corporation tax credits would be attributed only for corporation tax actually paid, any dividends distributed from this untaxed surplus would not carry a tax credit. We have recommended that such dividends should be regarded as a return of capital and should be applied to reduce the cost basis of the shares. This procedure would delay the imposition of tax, but when the shares were disposed of, or disposition was deemed to take place, this amount would be brought into income. Thus, we have included an amount in the tax base to reflect the fact that in a growing economy there will continue to be distributions from untaxed surplus. We allocated this amount among taxpayers in proportion to total dividends reported.

CHANGES IN 1964 TAXES ACCRUED AT THE CORPORATE LEVEL  
AS A RESULT OF OUR PROPOSALS (TABLE 35-6)

23. Total 1964 corporation tax revenues under the current tax legislation were assumed to be the amount actually reported in 1964 to the federal government before deducting any provincial tax credits—for Ontario or Quebec—or foreign tax credits. As this amount includes both the federal income and old age security taxes and the provincial income taxes for all provinces except Ontario and Quebec, with the abatements to these two provinces being included in the total by adding back the provincial tax credits, it is a slightly larger figure than would result if corporate taxable income was subject only to the dual rate of 21 per cent and 50 per cent. This small overstatement arises because the extra 1 per cent of tax levied by Manitoba and Saskatchewan is included in the provincial income tax total. The 1964 total corporation income tax declared of \$1,935 million was derived from preliminary figures for Table 1 of 1966 Taxation Statistics, Part Two which were supplied to us by the Department of National Revenue. The tax on section 105 distributions was estimated to total \$6 million in 1964, based on an extrapolation of data for previous years.

24. As is pointed out in Note 19, the figure of 47 per cent that we have employed to estimate the portion of the present corporation tax base that is attributable to residents cannot be similarly applied to all other amounts. In allocating the present corporation income tax revenues among residents and non-residents we applied this percentage to the tax that would have been payable if the full 50 per cent rate of tax had been applicable to all income, and then reduced this amount to reflect the estimated impact of the dual rate of corporation tax. For resident individuals \$177 million was deducted to reflect the dual rate, resulting in an attribution of a total of \$854 million in corporation income taxes to resident individuals and exempt institutions. We assumed that all of the \$6 million of section 105 tax was attributable to residents.



25. The portion allocable to non-residents of the amount by which tax at 50 per cent on the present corporation tax base would be reduced by the impact of the dual rate of tax was estimated to be \$81 million, based on an analysis of the distribution of non-resident ownership of companies in different income classes reporting under the Corporations and Labour Unions Returns Act.

26. Corporation taxes accrued under our proposals which are attributable to shares owned by residents, including the trustees of Registered Retirement Income Plans, were estimated at 50 per cent of the \$2,242 million of net corporation tax base shown in Table 35-5 as being attributable to residents.

27. Corporation taxes accrued under our proposals which are attributable to shares owned by non-residents were estimated at 50 per cent of the difference between the \$4,946 million of total corporation tax base shown in Table 35-4 and the \$2,242 million attributed to residents as indicated in Table 35-5.

28. Current corporation income taxes for 1964 in the amount of \$804 million attributable to resident individuals were allocated among taxpayers in proportion to the amount of the corporation tax base attributable to them. Of the total current corporation tax base attributable to resident individuals of \$1,962 million, the before-corporation-tax equivalent of the amount distributed to shareholders in section 105 allocations amounted to \$67 million and was allocated among taxpayers with currently taxable income in excess of \$25,000 in proportion to dividend income reported. The balance of the attributable corporate base was allocated among all taxpayers in proportion to dividends received. The \$6 million of tax on section 105 distributions was allocated in proportion to section 105 allocations and added to the corporation income tax attributed to each taxpayer. The allocation procedure is described in more detail in Appendix M to Volume 4, and in the programmes listed in J. Bossons, Analyzer, a study published by the Commission.

THE EFFECT OF PARTICULAR REFORMS ON EACH COMPONENT OF THE  
GROSS PERSONAL INCOME TAX BASE FOR 1964 (TABLE 35-7)

29. Attributable benefits include all those amounts expended by employers for the benefit of their employees that are not reported as salary or wages and that are not already included in the employees' incomes as taxable benefits. They also include other benefits, not now included in taxable income, that are received by individuals in exchange for services rendered or as benefits under various kinds of income insurance plans. The estimate of \$674 million reflects only benefits attributable to individuals currently filing tax returns. On the basis of data reported in various government publications, it is likely that benefits under income insurance plans alone (unemployment insurance, unemployment assistance, workmen's compensation, accident and sickness insurance, and group life insurance) aggregate roughly \$900 million. Most of the benefits not included in our estimate would be attributable to individuals who are not currently paying taxes and who would not be subject to tax under our proposals.

Attributable benefits were allocated to taxable returns on the basis of data contained in each of the individual tax returns in the sample of 417,000 tax returns provided to us by the Department of National Revenue. Of the total of \$674 million, top employee benefits amounted to \$28 million, other employee benefits to \$370 million, and benefits attributable to self-employed individuals amounted to \$276 million. Top employee benefits were estimated as 5 per cent of wages and salaries in excess of \$10,000. Other employee benefits were estimated as 2 per cent of wages and salaries up to a maximum of \$300 for all employees receiving more than \$2,500 in wage and salary income in 1964. Benefits attributable to self-employed individuals were estimated at 3 per cent of expenses, other than capital cost allowances, deducted in computing business and professional income. In all cases, total benefits attributable to any taxpayer were limited to no more than \$1,500; in addition, certain other constraints were placed on all estimates to remove possible anomalies. For full details, see the listing of the BENFITS function in J. Bossons, Analyzer.

30. The amounts added to the tax base because of the inclusion of capital gains and losses also reflect sundry other proposals we have made in order to arrive at a comprehensive tax base, for example, the taxation of net gambling gains. The data underlying our assumptions regarding capital gains and losses realized on corporate stock are outlined in Note 21, where it is pointed out that net capital gains on corporate stock were estimated at an amount equal to dividends currently reported by resident individuals. Net capital gains realized on the disposal of assets of unincorporated businesses were allocated on the basis of 8 per cent of net unincorporated business income reported on each 1964 individual tax return. Other gains, including real estate gains, gambling gains and other minor additions to the tax base, were allocated to individuals filing tax returns as 100 per cent of net rental income plus 15 per cent of income from fixed income securities and other Canadian non-equity investment income. The attribution process is described in programmes listed in J. Bossons, Analyzer. The resulting aggregate estimate of \$795 million of realized gains and losses also includes the effect of taxing non-residents on gains and losses realized on real property in Canada and on rights thereto.

Detailed statistics are not available concerning the amounts of property gains and losses now realized in Canada that are not subject to taxation. We have therefore relied to some extent on United States statistics in arriving at an estimate of the Canadian revenues which would result from the inclusion in income of all property gains and losses.

While the relative importance of capital gains as a source of revenue in the United States may not have been significant a number of years ago, this is no longer the case. For example, United States statistics indicate that while only 2 per cent of the personal tax returns filed in 1942 showed realized capital gains or losses, in 1962 about 9 per cent of the returns filed included this item. The relative proportion of total personal income tax derived from capital gains has also increased, with less than 1 per cent of personal income tax revenues derived from this source in 1942 and about 5 per cent in 1962. The total



net gains reported by individuals in the United States in 1962 (the excess of gross gains over gross losses, before the 50 per cent exclusion for net long-term gains and before the exclusion of non-deductible losses) amounted to \$11 billion, which is over 3 per cent of total United States adjusted personal gross income before the inclusion of net gains and losses.

In the five years 1960 to 1964 the United States raised on average almost 6 per cent of the personal income tax revenues from the taxation of capital gains, with a smaller proportion of corporation tax revenues being attributable to this source. This revenue yield was obtained despite the fact that in the United States realized capital gains are taxed at half rates, up to a maximum rate of 25 per cent, and gains or losses on dispositions by gift or bequest are specifically excluded from the income tax base. At the same time, the deduction of capital losses is restricted in the United States. However, some gains which are treated as capital gains in the United States are already taxable in Canada.

A number of adjustments have to be made to the United States figures in order to derive an estimate of the amount that might be expected to be realized as property gains and losses in Canada. However, a number of these adjustments tend to offset one another, with the result that we would expect the amounts shown in a special United States Treasury Department study of capital gains in 1962 to provide a reasonable indication of what could be expected in Canada. Detailed discussion of the necessary adjustments is contained in G. R. Conway, The Taxation of Capital Gains, a study published by the Commission. The following brief comments indicate the magnitude of the amounts involved.

In the year of the special study, 1962, capital gains and losses were relatively lower than in a number of other years. If the 1962 figures were adjusted to reflect an average of the gains and losses reported in proportion to other income over the five years 1960 to 1964, they would be increased by over 11 per cent.

Our review of the available material leads us to believe that the inclusion in income of gains and losses realized on dispositions of property by gift or bequest, and on the disposition deemed to occur when a taxpayer gave up his Canadian residence, would increase reported gains by a very substantial amount, as would the better reporting of gains and losses that could be expected under our proposals because of the requirement that taxpayers list all holdings of property. On the other hand, approximately one quarter of the gains and one fifth of the losses realized in the United States in 1964 were from sources that would either already be taken into account under the present Canadian system or would be excluded from income under our proposals. In addition our proposals for the integration of the personal and corporation income taxes would eliminate that portion of the gains realized on the disposal of common shares that was attributable to retained earnings. If we assume that this would have eliminated half the gains realized on common stock in the United States in 1962, the total United States gains would have been reduced by another quarter. Also, the amount of reported capital losses would have been increased.

We estimate that the net effect of all the above adjustments would have been to increase the total amount of gross gains reported in the United States in 1962 by 35 per cent to 40 per cent and of gross losses by over 10 per cent. We refer to gross gains and gross losses as we propose that the full amount of gains and losses realized should be included in the comprehensive tax base.

An adjustment is also required to reflect the fact that on average Canadians realize a lower proportion of their income in the form of investment income than do United States citizens. Thus, it would be expected that the proportions of realized gains and losses to other income would generally be lower in Canada than in the United States. We have used the relative amounts of dividend income received as a basis for estimating what the relative proportions would be for gains and losses. Not only are the amounts of dividends reported a better basis for comparison between the two countries than the amounts

for investment income generally, because of the United States exemption for state and local government bond interest, but also it could be expected that realized gains and losses would more closely parallel dividend income than an amount that included income from fixed income securities. In Canada dividend income amounts to about 1.7 per cent of income (as that term is currently understood), while in the United States it amounts to about 3.2 per cent of adjusted gross income before including net gains and losses. Thus, in both cases the percentage is calculated on a figure which is determined without taking gains and losses into account. While Canadians with income between \$10,000 and \$25,000 appear to derive more of their income in the form of dividends than do United States citizens in the same income bracket, the balance of Canadians have relatively less dividend income.

Applying all of the above adjustments would mean that the United States figure for total net gains (gross gains less gross losses) of 3.2 per cent of adjusted gross income before such gains and losses were taken into account would be reduced under our proposals to the equivalent of about 2.7 per cent of income assessable under Canadian tax law. Applying this percentage to the \$27 billion of assessable income reported in Canada in 1964, and adding to the result approximately \$70 million for other small additions to the tax base of resident individuals, including net gambling gains, and for net gains on real property realized by non-residents, would result in a net amount of gains and losses realized by individuals of about \$800 million.

31. Increases in investment income were estimated by reconciling estimates based on individual tax return data with aggregate estimates based on other sources.

Unreported interest was assumed to be 70 per cent of reported non-dividend Canadian personal investment income up to a maximum of \$1,000 for each taxpayer, resulting in an aggregate estimate of \$377 million. This increase in the base was equivalent to about 50 per cent of non-dividend Canadian investment income. "Non-dividend Canadian investment income" excluded



income from dividends and annuities but included non-dividend income from trusts; the increase in the tax base resulting from the inclusion of unreported interest amounted in the aggregate to 58 per cent of "non-dividend Canadian investment income" less non-dividend income from trusts. On the basis of estimates made in the United States by D. M. Holland, "Unreporting of Dividends and Interest on Tax Returns", Volume 2, Tax Revision Compendium, Washington: United States Government Printing Office, 1959, p. 1397, and of discussions with the Department of National Revenue, we believe that the improved reporting requirements we recommend and the proposed partial accrual approach should increase reported interest income by more than 60 per cent so that the estimates we have used probably understate the amount of the total increase. The Holland paper estimated that unreported interest actually exceeded reported interest in the United States in 1957. Reported interest in the United States is reduced by the exemption for state and local bond interest, but even after adjusting for this amount Professor Holland estimated that unreported interest on average exceeded 90 per cent of the amount that would be equivalent to interest reported in Canada. For persons with adjusted gross income of under \$7,000, this figure was estimated to be 110 per cent.

Information supplied to us by the Department of Insurance indicates that the amounts to be included in the income of Canadian life insurance policyholders for policyholder investment income and participating dividends would total about \$500 million. We allocated these items in accordance with a base defined as 4 times non-dividend Canadian investment income plus currently assessable income in excess of \$3,000, reduced by 30 per cent for taxpayers over 65 years of age to reflect a likely reduction in attributable policyholder investment income for such taxpayers. The two items combined were estimated at about 1.7 per cent of this adjusted base. The precise estimating procedure is detailed in J. Bossons, Analyzer. The resulting aggregate estimates of policyholder participating dividends and investment income attributed to policyholders amounted to \$174 million and \$312 million, respectively. We

have employed figures lower than the aggregate estimated change in the tax base because some of the amounts would be attributable to individuals who would not pay taxes either under the current system or under our proposals.

The \$4 million entry under "Income From Corporate Shares" in Table 35-7 represents stockholder depletion allowances which would not be deductible under our proposals. Based on a detailed analysis of 1961 tax return data for an unidentified group of upper income taxpayers, stockholder depletion allowances were assumed to be 33 per cent of investment expenses claimed by taxpayers with investment expenses over \$600 and dividend income in excess of \$2,000.

32. Figures supplied by the Department of National Revenue show that gifts reported in 1964 on taxable and non-taxable returns totalled approximately \$165 million. Table 2, 1965 Taxation Statistics, Part Two, shows that the aggregate net value of estates for the 1964-65 fiscal year was \$818 million. Based upon figures reported in Volumes I and III of the 1964 Annual Report of the Superintendent of Insurance for Canada, we estimate that the amount of death claims paid under life insurance policies to Canadians that were not included in the net value of estates mentioned above exceeded \$225 million. To these figures must be added that portion of those gifts and bequests that is not now subject to tax, either because of the exclusions provided under the gift or estate tax legislation or because they are received from non-residents, and that exceeds the exclusions we propose. More explicit legislation and stricter reporting requirements should also reduce tax avoidance. From the total amount of estimated gifts and bequests exceeding the proposed exclusion for small amounts must be deducted an estimate of the amount of transfers that would be received by tax units who did not file tax returns in 1964 and who would continue to be non-taxable under our proposals. The foregoing factors would result in an estimate for transfers, in excess of exclusions, to individuals filing tax returns of about \$2,000 million. From this amount there must be deducted an estimate of transfers within the family unit. Based upon information contained in Carl S. Shoup, Federal Estate and Gift Taxes, Washington: Brookings Institution, 1965, and upon data provided

by the Ontario Committee on Taxation, we have reduced the above estimate of \$2,000 million by 40 per cent to arrive at an estimate for taxable gifts and bequests received from outside the family unit as we have defined it. The allocation of the resultant \$1,200 million aggregate estimate among individual taxpayers is described in the programme listing provided in J Bossons, Analyzer. In our estimates of incidence under the present tax system, existing taxes on gifts and bequests were allocated in proportion to estimated gifts received.

33. The amount of child support transfer payments to be added to the tax base consists of family allowances, family assistance payments and youth allowances. The total payments received were estimated for each tax return filed on the basis of estimates of the number of children receiving family allowances and of the number of other dependants claimed by each taxpayer computed from total exemptions claimed and from additional marital status data. The estimating procedure is summarized in J. Bossons, Analyzer, particularly in the notes to Table B-6 and in the listings of subroutines FAMPAR and BASADJ. In projecting family characteristics and family and youth allowances from the estimates of the numbers of each type of exemptions claimed it was assumed that 70 per cent of dependants for whom \$550 exemptions were claimed were dependent children if the claiming taxpayer filed as married, that 30 per cent of these dependants were eligible for youth allowances of \$120 a year. It was also assumed that family allowances received for each eligible child amounted to \$80.60 a year. These assumptions are based on figures contained in The National Finances, 1964-65 and 1965-66, Toronto: Canadian Tax Foundation. On the basis of the 417,000 tax return sample, these assumptions imply aggregate estimates of 5,120,000 dependants eligible for family allowances and 489,000 dependants eligible for youth allowances for the 6,720,000 individuals filing tax returns. Family allowance and youth assistance payments of approximately \$120 million are not included in the estimate. This amount represents the child support transfer payments which are received by family units who currently do not file tax returns and who even under our proposals would continue to have incomes of less than the allowed exclusions.



34. There is almost no information available on which to base an estimate of the revenue implications of the proposals affecting unincorporated business income. The recommended accelerated depreciation for new and small businesses would be of relatively less value for the average unincorporated business than for the average small corporation, since over three quarters of the income of unincorporated businesses is derived by businesses in the service, retail or wholesale trade industries where the proportion of depreciable assets to total assets is generally smaller than for other industries. It would also appear that relatively small amounts of losses are now ineligible for deduction because of the limit on the loss carry-forward and the limit to one year on their deduction from other income. Also, our proposed limit on the deduction of "hobby business" losses would increase tax revenues. Again we assume both increases and decreases in revenue from the changes in the definition of business income for tax purposes and an increase in revenue from the elimination of many tax avoidance techniques.

Our aggregate estimate of a \$56 million reduction in the tax base has been pro-rated over individual tax returns generally in proportion to total net income from unincorporated business reported on each return. The major portion of this figure, \$49 million, represents our estimate of the effect of the recommended accelerated capital cost allowances for new and small businesses, and is allocated to individuals as 5 per cent of the net income from unincorporated business for each individual filing a tax return. The net effect of the proposals affecting the deductibility of business losses was assumed to be equivalent to allowing the deduction of five times the actual prior year's business loss deducted on each tax return in 1964, resulting in an estimated aggregate reduction in the personal income tax base of \$7 million.

35. Additional employment expenses deductible, in excess of those that are already deductible under the present legislation, were estimated for each tax return in the 1964 Taxation Statistics sample from data on age, wages

and salaries received, and union and professional dues deducted in 1964. The analysis is shown in detail in the programme listings of functions EMPLXP, OPXDED, and UICON presented in J. Bossons, Analyzer. Based on an assumption that 73 per cent of taxpayers reporting wage and salary income are covered by unemployment insurance, application of the standard method of computing unemployment insurance premiums yielded an estimate of \$150 million for aggregate premiums paid by individuals filing tax returns in 1964. We estimated that an additional \$622 million would become deductible under the general allowance of expenses incurred to earn employment income. Most of this total would result from the provision of the optional 3 per cent employment expense allowance, while the balance would be deducted through the claiming of specific expenses aggregating more than the 3 per cent of income.

36. As is shown in Table 35-5, the total 1964 corporation tax base attributable to resident individuals under our proposals would be \$2,142 million. As is stated in Note 22, it was assumed that 95 per cent of dividends received by residents would carry a credit for corporation tax paid and would be grossed-up to include such tax. Deducting these dividends from the corporate base attributable to individuals resulted in an estimated net addition to the income of resident individuals of \$1,714 million. From this amount the net increase of \$180 million in the corporation tax base attributable to resident individuals, which is shown separately, was deducted to show the effect of integration alone. The remaining sum of \$1,534 million was allocated among persons filing tax returns in the manner described in Note 28.

37. The method of determining the increase in the integrated corporation tax base is described in Note 19. It was allocated among persons filing tax returns in the manner described in Note 28.

INCREASE IN THE PERSONAL INCOME TAX BASE AS A RESULT OF PARTICULAR  
REFORMS IN CONCESSIONARY ALLOWANCES AND FAMILY EXEMPTIONS  
DEDUCTED IN COMPUTING TAXABLE INCOME (TABLE 35-9)

38. The amount of personal exemptions was derived by estimating for each tax return the number of \$1,000 exemptions claimed. These in turn were estimated for each return filed from data on the total exemptions claimed and marital status reported, as described in the notes to Table B-6 in J. Bossons, Analyzer. These estimates imply a total of 6,660,000 basic \$1,000 and \$2,000 exemptions claimed by a total of 6,720,000 individuals filing tax returns in 1964; the balance of 60,000 returns is accounted for by partially non-resident taxpayers. It should be noted that this number is overstated as a result of the Department's practice of understating total exemptions for partially non-resident taxpayers by the amount by which the standard deduction, if taken, has to be increased to make it equivalent to the full standard deduction.

The estimates of exemptions were obtained from data on each return in the 1964 sample; the only published data which can be used as the basis for such estimates are those contained in Table 7 of 1966 Taxation Statistics, Part One, which excludes non-taxpayers.

39. The estimate of exemptions for dependants was obtained in the manner described in Note 33. The underlying estimates made for each taxpayer imply a total of 5,120,000 dependants receiving family allowances and 1,450,000 other dependants.

40. Deductible educational expenses consist of tuition expenses in excess of \$25 under current tax law; they are assumed to be 90 per cent of miscellaneous deductions excluding investment expenses and prior year business losses.

41. The proposal to eliminate the special \$500 exemption for individuals of age 70 or more and for persons who are blind or confined to a bed or wheelchair would increase the tax base of individuals filing tax returns



in 1964 by at least \$142 million. This amount excludes the deductions formerly allowed to those from 65 to 69 years of age, which are reflected in Table 35-2. The estimate is based on the 1966 Taxation Statistics, Part One, in which it is reported that about 265,000 individuals filing tax returns in 1964 were age 70 or more. In addition more than 15,000 individuals would have claimed the \$500 exemption for being blind or confined to a bed or wheelchair.

The amount of medical expenses claimed would be decreased by the proposed limitation of the deduction to amounts paid by the taxpayer directly, instead of continuing to allow the deduction of amounts paid by insurers on behalf of the taxpayer. Because the 3 per cent floor would continue to apply, most taxpayers would find that their premium payments plus expenditures on non-insured medical costs would not exceed the limitations by very much--if at all. However, we have assumed that the increase in the base resulting from this change would be almost completely offset by the additional itemizing of medical expenses that would result from reducing the \$100 standard deduction to \$50 and limiting its applicability to charitable donations alone. However, the tax base would be increased by the proposed elimination of the special exemptions for the blind and disabled. We have included a net increase in the tax base of \$7 million to reflect these changes in deductible medical expenses.

42. Our estimates of the change in the tax base resulting from our proposals for the control and definition of charitable donations and the reduction of the standard deduction are described in the programmes listed in J. Bossons, Analyzer. Of the total addition to the tax base of \$356 million for these items, \$228 million is estimated to be derived from the reduction in the standard deduction from \$100 to \$50, after assuming that 20 per cent of the reduction would be offset by an increase in the amount of charitable donations reported and claimed.

TAX CREDITS APPLICABLE TO PERSONAL INCOME TAXES  
FOR RESIDENTS IN 1964 (TABLE 35-11)

43. The amount of tax credits for dependants has been based on data for numbers of dependants estimated by the procedure described in Note 33. For 1964 dependent children of all individuals filing tax returns were estimated to total 6,135,000; other dependants were estimated to total 435,000.

44. On the basis of an assumed average tuition expense of \$400 per eligible taxpayer, tuition expenses have been assumed to be slightly larger than educational expenses estimated in the manner discussed in Note 40. The estimate of the number of students whose tuition expenses were deductible for each taxpayer was based on this assumed average tuition expense and the total tax credits were calculated for each eligible taxpayer as \$400 per student, \$300 for living expenses and \$100 for tuition expenses. Because tuition expenses are currently deductible only if the taxpayer was himself enrolled in a post-secondary educational institution, it was assumed that all such taxpayers would be eligible for the credit for living expenses, which would be limited to taxpayers outside the family unit. Details of the calculations are provided by the programmes listed in J. Bossons, Analyzer.

45. Credits applicable to income components include foreign tax credits of \$14 million and credits for working wives of \$49 million. In order to arrive at the amount which might be claimed under this provision, we assumed that all married female taxpayers filing as single for tax purposes were working mothers. More precise estimates would need data prepared on a family tax unit basis.

46. Current corporation taxes attributable to resident individuals were allocated as described in Note 28. This amount does not include the allowance for the net effect of extending the corporation tax credit to certain tax-exempt intermediaries (Note 20).

TOTAL PERSONAL INCOME TAXES UNDER THE CURRENT AND  
PROPOSED TAX SYSTEMS (TABLE 35-13)

47. Unused credits are the result of a taxpayer's being eligible for tax credits which are greater than the tax payable before credits are applied.

48. The effect of aggregating income in family tax units cannot properly be estimated without classifying and merging the separate tax returns of individuals presumed to be members of a family unit. This projection is based on the results of a matching run done by the Department of National Revenue on its taxpayer identification file to obtain a cross-classification of paired husbands and wives and matched children and parents, all classified by income class. The estimate is based on reported currently taxable income and to some extent is understated by not being based on our concept of comprehensive income.

49. This effect of our proposals for additional income averaging procedures is based on a crude adjustment of an estimate prepared for the Department of Finance of the effect of a general averaging proposal that involved no restrictions on the required amount of variation in income.





CALCULATION OF THE CHANGE WHICH WOULD OCCUR UNDER OUR PROPOSALS  
IN THE TAXES PAID BY SEVEN SAMPLE GROUPS OF TAXPAYERS

The purpose of this appendix is twofold:

1. To show in detail in a number of examples how taxes have been calculated for each group of taxpayers in the sample underlying our revenue estimates.
2. To set out the basic data underlying all calculations for these example groups so that the data can be used as the basis for subsequent illustrations of the way in which various summary tables have been prepared.

In order to reduce the number of calculations to be made, the 417,000 personal income tax returns for 1964 in the 1966 Taxation Statistics sample were classified into a smaller number of groups. Tax returns were classified by income, by a "preliminary family status" variable reflecting marital and family status and the work status of the taxpayer's spouse, by a "dependant status" variable reflecting the total number of dependants and the number claimed by the taxpayer to be eligible for family allowances, by a combined age/occupation/sex variable, and by whether the taxpayer did or did not pay taxes in 1964. The number of classes in each classification was as follows:

- 47 income classes
- 7 "preliminary family status" classes
- 15 "dependant status" classes
- 26 age/occupation/sex classes
- 2 tax-paying status classes

Thus, a total of 256,460 different cross-classifications of tax returns was possible. In fact, because no tax returns were found to accord with particular combinations of characteristics in a large number of cases, it turned out that classifying 1964 tax returns in this way resulted in 19,370 groups of one or more taxpayers 1/. The variables underlying the classification

of taxpayers are shown in Table B-1, which presents the range of values of each variable for each of the seven groups shown as examples in this appendix.

Data from individual 1964 tax returns falling within each classification were aggregated to collect 46 variables for each of these 19,370 groups. The data collected for the seven groups chosen as examples are presented in Table B-2.

The calculation of average taxes under the current and proposed tax systems for each of the seven example groups is shown in Tables B-3 to B-9 inclusive. These tables show our estimates of the major effects of our proposals for each component of income and for each major category of concessionary allowances and tax credits for the average taxpayer in each group. The change in total direct taxes shown in these tables excludes the effect of the deferment of tax on the investment income of Registered Retirement Income Plans allocable to each taxpayer. The assumptions on which our estimates are based are summarized in Appendix A to this Volume; a complete description is provided by programme listings presented in a study published by the Commission 2/ . Needless to say, our estimates are forecasts of what would happen on the average and are not necessarily accurate in particular cases.

The income components shown in Tables B-3 to B-9 inclusive consist of income from each source included in the personal income tax base, and have been adjusted to take account of changes in tax law between 1964 and 1966. Income not currently included in the personal income tax base but currently taxed through other direct taxes is reflected in the amounts reported for purposes of those taxes. Given total income, concessionary allowances, and tax credits allowed under each system for the average taxpayer in each class, personal income taxes payable are calculated using 1966 tax rates under the current system and the rate schedule presented in Chapter 11 under the proposed system. Other taxes are allocated in accordance with the assumptions summarized in Appendix A to this Volume.



In several subsequent appendices, totals are shown for all taxpayers classified into 20 income classes, which are defined in Table B-10. These income classes are based on comprehensive income rather than on currently taxable income because of the more accurate measurement of economic power provided by the former.

Summary data for the average taxpayer in each of the seven example groups are shown in Table B-11. This table also classifies these examples by comprehensive income class.

## REFERENCES

- 1/ The classification of the sample is discussed in detail in J. Bossons, A General Income Tax Analyzer, a study published by the Commission and hereinafter referred to as Analyzer.
- 2/ J. Bossons, Analyzer.

TABLE B-1

DESCRIPTION OF TAXPAYERS PLACED  
IN EACH EXAMPLE GROUP

	Example Group						
	1	2	3	4	5	6	7
Age	26-39	26-39	26-39	40-64	26-39	21 or under	65 and over
Sex	Male	Male	—	Male	Male	Male	Male
Marital status <u>a/</u>	Married	Married	Married	Married	Married	Single	Single
Number of dependants receiving family allowances <u>b/</u>	1	0	More than 4	More than 4	2	0	0
Number of other dependants <u>b/</u>	0	0	0	0	0	0	0
Occupation <u>c/</u>	Employee	Employee	Professional or proprietor	Investor	Employee	—	Pensioner
Income <u>d/</u>	\$5,500-5,999	\$12,000-12,999	\$30,000-34,999	\$30,000-34,999	\$50,000-74,999	\$3,000-3,499	\$1,500-1,749
Number of taxpayers	10,434	123	61	6	18	3,214	1,735
Number of tax returns sampled	408	28	61	6	18	149	68

## Notes:

a/ Marital status as used here means marital status for tax purposes. In fact, a somewhat more complicated "preliminary family status" classification was used in grouping tax returns, described in Tables B-1 and B-2 of J. Bossons, Analyzer, a study published by the Commission. The first five examples are all from preliminary family status class 1, the sixth from class 6, and the seventh from class 7.

b/ The number of dependants of each type was estimated from data on total personal exemptions as described in the notes to Table B-6 in J. Bossons, Analyzer.

c/ Taxpayers were classified by method of earning income rather than by type of work performed. Thus, a professional engineer and accountant working as a company employee was classed as an employee. The classification by occupation is described in Table B-5 of J. Bossons, Analyzer. The age/occupation/sex classification of the seven example groups is 5, 5, 8, 18, 5, 1 and 25 respectively.

d/ "Income" is total assessable income under 1964 tax law, after the deduction of allowable expenses incurred in the earning of income other than investment income but before the deduction of concessionary allowances and family exemptions.



TABLE B-2

## DATA ACCUMULATED FOR EACH EXAMPLE GROUP OF TAXPAYERS

	Example Group						
	1	2	3	4	5	6	7
1. Number of taxpayers	10,434	123	61	6	18	3,214	1,735
Personal exemptions							
2. Number of \$1,000 exemptions a/	20,867	245	122	10	35	3,214	1,725
3. Number of \$550 exemptions	0	0	0	0	0	0	0
4. Number of \$300 exemptions	10,434	0	335	30	36	0	0
5. Number of old age exemptions	0	0	0	0	0	0	1,725
6. Total personal exemptions (\$000)	23,997.2	245.0	2,212.5	19.0	415.8	3,214.0	25,912.5
Personal deductions							
7. Number of taxpayers claiming standard deductions	6,102	75	5	1	7	2,823	1,575
8. Number of taxpayers claiming medical deductions	2,392	1	1	0	1	81	60
9. Gross medical expenses (\$000)	854.7	0.6	1.2	0	1.0	27.0	9.3
10. Net medical deductions (\$000)	458.2	0.2	0.3	0	0.1	19.8	6.3
11. Number of taxpayers deducting union or professional dues	2,655	25	3	0	0	40	20
12. Dues deducted (\$000)	130.2	0.8	0.7	0	0	1.1	0.4
13. Number of taxpayers deducting both dues and medical expenses	1,210	0	0	0	0	20	20
14. Number of taxpayers claiming donations	3,860	47	56	5	11	370	140
15. Donations allowed (\$000)	794.2	20.1	48.0	4.5	10.4	67.4	17.9
Income from employment, business or profession (\$000)							
16. Employment income	59,641.1	1,392.1	89.1	37.4	936.6	8,918.5	742.2
17. Net business income	8.9	0.2	104.8	0	2.8	1,139.5	0
18. Net professional income	3.0	4.6	1,693.7	0	0	8.7	4.5
19. Net income from commissions	90.0	75.4	62.6	0	6.6	61.5	2.0
20. Net income from farming or fishing	17.5	0	9.1	2.2	0	190.6	12.5
21. Net rental income	100.5	0.1	1.1	13.1	21.9	67.1	3.3
22. Capital cost allowances	184.8	3.2	58.7	3.6	21.7	674.6	0
23. Business and professional expenses, excluding capital cost allowances b/	115.5	1.9	1,266.7	0	17.8	1,369.2	0
24. Prior year's business loss	0	0	0	0	0	0	0
Investment income, deductions and credits (\$000)							
25. Gross dividends from Canadian companies c/	38.1	2.4	7.6	78.8	64.9	12.0	30.5
26. Annuity income	0	0	0.3	0	0	0	16.1
27. Other Canadian investment revenue d/	57.3	59.0	13.4	60.6	29.0	75.3	649.4
28. Foreign investment income	0	0.4	0.2	0.17	0.2	0	0
29. Deductions from investment income	8.7	1.6	2.9	14.4	30.8	0.5	0
30. Dividend tax credit	7.1	0.5	1.1	14.4	11.1	2.3	0.3
31. Foreign tax credit	5.5	4.9	—	0.1	0.1	0	0
Other income (\$000)							
32. Old age pension	0	0	0	0	0	0	1,401.0
33. Alimony received	0	0	0	0	0	0	0
34. Other income e/	157.4	0.1	0.2	0	0.6	15.0	60.1
35. Income of spouses earnings less than \$1,250 f/	0	0	0	0	0	0	0

(continued)

TABLE B-2 (continued)  
DATA ACCUMULATED FOR EACH EXAMPLE GROUP OF TAXPAYERS

	Example Group						
	1	2	3	4	5	6	7
Other deductions (\$000)							
36. Pension contributions	1,398.2	43.3	8.9	0.6	12.1	102.2	0
37. Retirement savings premiums	4.8	1.2	67.5	1.5	1.6	0.1	0
38. Alimony paid	36.8	0	0	0	0	54.5	0
39. Other deductions	185.9	5.6	0.1	0	0	46.5	—
Total income, deductions and taxes (\$000)							
40. Total income	59,877.8	1,533.8	1,963.5	192.7	1,062.5	10,488.0	2,921.8
41. Total deductions	27,624.5	324.7	351.3	40.1	101.5	3,783.5	2,774.6
42. Federal income tax payable in 1964	3,755.6	209.7	466.0	31.6	337.8	701.2	13.7
43. Provincial tax collected in 1964	559.4	21.0	69.7	7.3	46.5	109.7	1.6
44. Old age security tax	1,220.0	14.8	7.3	0.7	2.2	266.7	5.2
Miscellaneous							
45. Number of taxpayers liable for Quebec income tax	3,779	67	20	—	7	1,005	775

Notes: a/ The number of \$1,000 exemptions for a taxpayer may be fractional or even negative as a result of adding to this sum all fractional residual amounts arising from a taxpayer's immigration to or emigration from Canada or from deemed partial residence of a non-resident taxpayer. All other numbers of personal exemptions are assumed to be integers, as are numbers of \$100 standard deductions claimed. The residual amounts arise from assuming these latter numbers to be integral in our calculations.

b/ Computed as the difference between each taxpayer's gross income from business and professional proprietorships and partnerships (prorated by share of net income in the case of a partnership) and net income from these sources, less total capital cost allowances claimed by the taxpayer. Capital cost allowances deductible from other gross income have not been segregated from total capital cost allowances, and total business and professional expenses are consequently understated. If the (understated) estimate of expenses is negative for a taxpayer, it is arbitrarily revised to zero before being added into the total for the class.

c/ Includes dividends received as estate income where shown separately on 1964 tax returns filed.

d/ Includes bond and bank interest, mortgage interest, estate income and other investment income from Canadian sources.

e/ Corresponds to the entry entitled "Miscellaneous Income" in tables to be published in 1966 Taxation Statistics, Ottawa: Queen's Printer.

f/ Estimated in imputing numbers of dependants for a taxpayer. See notes to Table B-6 in J. Bossons, Analyzer, a study published by the Commission.

TABLE B-3

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 1

<u>Deductions</u>		<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 134	\$ 134		1. Wages and salaries	\$ 5,716	\$ 5,716
2. Retirement savings	79	79		2. Employment expense deductions	(12)	(204)
3. Net medical expenses	44	43		3. Professional income	—	—
4. Charitable donations	76	59		4. Commission income	9	9
5. Standard deductions	58	32		5. Attributable benefits	—	115
6. Alimony paid	4	4		6. Farming and fishing income	(2)	(2)
7. Other deductions	<u>18</u>	<u>22</u>		7. Dividends	4	4
Total deductions	413	353		8. Other corporate income	—	13
Family exemptions	<u>2,300</u>	<u>—</u>		9. Capital gains on shares	—	4
Total deductions and family exemptions	<u>\$2,713</u>	<u>\$353</u>		10. Unincorporated business income	1	—
				11. Net rental income	(10)	(10)
				12. Other Canadian investment income	5	106
				13. Non-business capital gains	—	(9)
				14. Foreign investment income	—	—
				15. Deductions from investment income	(1)	(1)
				16. Gifts and bequests	—	31
				17. Transfer payments	—	81
				18. Alimony received	—	—
				19. Miscellaneous income	<u>15</u>	<u>15</u>
				Total income	\$5,725	\$5,868
				Less: total deductions and family exemptions	<u>2,713</u>	<u>353</u>
				Taxable income	<u>\$3,012</u>	<u>\$5,515</u>
<u>Tax Credits</u>				<u>Tax Calculation</u>		
1. Credits for dependants	\$ —	\$ 100		Personal income tax before tax credits	\$522	\$555
2. Dividend tax credits	1	—		Less: total tax credits	<u>2</u>	<u>126</u>
3. Refundable credits for corporation income tax	—	8		Personal income tax including old age security tax	\$521	\$429
4. Other tax credits	<u>1</u>	<u>18</u>		Corporation income tax	6	8
Total tax credits	\$ <u>2</u>	\$ <u>126</u>		Taxes on gifts and bequests received	—	—
				Total direct taxes	\$528	\$437

Note: Some columns do not add to totals due to rounding.



TABLE B-4

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 2

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 352	\$ 352	1. Wages and salaries	\$11,318	\$11,318
2. Retirement savings	89	89	2. Employment expense deductions	(6)	(372)
3. Net medical expenses	2	(1)	3. Professional income	37	37
4. Charitable donations	163	141	4. Commission income	613	613
5. Standard deductions	61	34	5. Attributable benefits	—	293
6. Alimony paid	—	—	6. Farming and fishing income	—	—
7. Other deductions	<u>41</u>	<u>4</u>	7. Dividends	19	19
Total deductions	708	619	8. Other corporate income	—	71
Family exemptions	<u>1,992</u>	<u>—</u>	9. Capital gains on shares	—	19
Total deductions and family exemptions	<u>\$2,700</u>	<u>\$619</u>	10. Unincorporated business income	(1)	(3)
			11. Net rental income	1	1
			12. Other Canadian investment income	479	1,056
			13. Non-business capital gains	—	72
			14. Foreign investment income	3	3
			15. Deductions from investment income	(13)	(13)
			16. Gifts and bequests	—	1,550
			17. Transfer payments	—	—
			18. Alimony received	—	—
			19. Miscellaneous income	<u>1</u>	<u>1</u>
			Total income	\$12,450	\$14,666
			Less: total deductions and family exemptions	<u>2,700</u>	<u>619</u>
			Taxable income	<u>\$9,750</u>	<u>\$14,047</u>
<u>Tax Credits</u>			<u>Tax Calculation</u>		
1. Credits for dependants	\$ —	\$ —	Personal income tax before tax credits	\$2,195	\$2,398
2. Dividend tax credits	4	—	Less: total tax credits	<u>44</u>	<u>123</u>
3. Refundable credits for corporation income tax	—	45	Personal income tax including old age security tax	2,152	2,275
4. Other tax credits	<u>40</u>	<u>79</u>	Corporation income tax	33	45
Total tax credits	<u>\$44</u>	<u>\$123</u>	Taxes on gifts and bequests received	<u>207</u>	<u>—</u>
			Total direct taxes	<u>\$2,392</u>	<u>\$2,319</u>

Note: Some columns do not add to totals due to rounding.

TABLE B-5

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 3

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 146	\$ 146	1. Wages and salaries	\$ 1,461	\$ 1,461
2. Retirement savings	1,248	1,248	2. Employment expense deductions	(11)	(70)
3. Net medical expenses	4	4	3. Professional income	27,765	27,765
4. Charitable donations	787	771	4. Commission income	1,020	1,020
5. Standard deductions	8	5	5. Attributable benefits	—	623
6. Alimony paid	—	—	6. Farming and fishing income	(149)	(149)
7. Other deductions	<u>2</u>	<u>—</u>	7. Dividends	124	124
Total deductions	\$2,195	\$2,174	8. Other corporate income	—	510
Family exemptions	<u>3,648</u>	<u>—</u>	9. Capital gains on shares	—	124
Total deductions and family exemptions	<u>\$5,843</u>	<u>\$2,174</u>	10. Unincorporated business income	1,719	1,808
			11. Net rental income	18	18
			12. Other Canadian investment income	224	932
			13. Non-business capital gains	—	51
			14. Foreign investment income	3	3
			15. Deductions from investment income	(48)	(48)
			16. Gifts and bequests	—	5,994
			17. Transfer payments	—	443
			18. Alimony received	—	—
			19. Miscellaneous income	<u>3</u>	<u>3</u>
			Total Income	\$32,129	\$40,611
			Less: total deductions and family exemptions	<u>5,843</u>	<u>2,174</u>
			Taxable income	<u>\$26,286</u>	<u>\$38,437</u>
<u>Tax Credits</u>			<u>Tax Calculation</u>		
1. Credits for dependants	\$ —	\$ 370	Personal income tax before tax credits	\$9,313	\$10,483
2. Dividend tax credits	18	—	Less: total tax credits	<u>18</u>	<u>685</u>
3. Refundable credits for corporation income tax	—	314	Personal income tax including old age security tax	\$9,295	\$ 9,798
4. Other tax credits	<u>—</u>	<u>2</u>	Corporation income tax	240	314
Total tax credits	\$ <u>18</u>	\$ <u>685</u>	Taxes on gifts and bequests received	<u>832</u>	<u>—</u>
			Total direct taxes	<u>\$10,368</u>	<u>\$10,112</u>

Note: Some columns do not add to totals due to rounding.

TABLE B-6

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 4

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 93	\$ 93	1. Wages and salaries	\$ 6,235	\$ 6,235
2. Retirement savings	329	329	2. Employment expense deductions	—	(219)
3. Net medical expenses	—	—	3. Professional income	—	—
4. Charitable donations	750	744	4. Commission income	—	—
5. Standard deductions	17	9	5. Attributable benefits	—	125
6. Alimony paid	—	—	6. Farming and fishing income	362	362
7. Other deductions	—	—	7. Dividends	12,341	13,133
Total deductions	1,189	1,175	8. Other corporate income	—	54,038
Family exemptions	<u>3,167</u>	—	9. Capital gains on shares	—	13,133
Total deductions and family exemptions	<u>\$4,356</u>	<u>\$1,175</u>	10. Unincorporated business income	—	(30)
			11. Net rental income	2,177	2,177
			12. Other Canadian investment income	10,102	12,316
			13. Non-business capital gains	—	3,692
			14. Foreign investment income	108	108
			15. Deductions from investment income	(1,609)	(1,609)
			16. Gifts and bequests	—	12,726
			17. Transfer payments	—	403
			18. Alimony received	—	—
			19. Miscellaneous income	—	—
			Total income	\$29,715	\$116,589
			Less: total deductions and family exemptions	<u>4,356</u>	<u>1,175</u>
			Taxable income	<u>\$25,359</u>	<u>\$115,414</u>
<u>Tax Credits</u>			<u>Tax Calculation</u>		
1. Credits for dependants	\$ —	\$ 340	Personal income tax before tax credits	\$8,850	\$46,384
2. Dividend tax credits	2,402	—	Less: total tax credits	<u>2,418</u>	<u>33,613</u>
3. Refundable credits for corporation income tax	—	33,257	Personal income tax including old age security tax	\$6,432	\$12,771
4. Other tax credits	<u>16</u>	<u>16</u>	Corporation income tax	25,473	33,257
Total tax credits	<u>\$2,418</u>	<u>\$3,613</u>	Taxes on gifts and bequests received	<u>1,660</u>	—
			Total direct taxes	<u>\$33,565</u>	<u>\$46,028</u>

Note: Some columns do not add to totals due to rounding.



TABLE B-7

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 5

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 674	\$ 674	1. Wages and salaries	\$52,034	\$52,034
2. Retirement savings	165	165	2. Employment expense deductions	—	(1,532)
3. Net medical expenses	4	4	3. Professional income	—	—
4. Charitable donations	577	559	4. Commission income	364	364
5. Standard deductions	39	21	5. Attributable benefits	—	1,500
6. Alimony paid	—	—	6. Farming and fishing income	—	—
7. Other deductions	—	—	7. Dividends	3,042	3,607
Total deductions	\$1,459	\$1,424	8. Other corporate income	—	14,842
Family exemptions	2,544	—	9. Capital gains on shares	—	3,607
Total deductions and family exemptions	<u>\$4,003</u>	<u>\$1,424</u>	10. Unincorporated business income	153	105
			11. Net rental income	1,219	1,219
			12. Other Canadian investment income	1,010	3,707
			13. Non-business capital gains	—	1,460
			14. Foreign investment income	8	8
			15. Deductions from investment income	(1,147)	(1,147)
			16. Gifts and bequests	—	16,197
			17. Transfer payments	—	161
			18. Alimony received	—	—
			19. Miscellaneous income	34	34
			Total income	\$57,316	\$96,167
			Less: Total deductions and family exemptions	4,003	1,424
			Taxable income	<u>\$53,315</u>	<u>\$94,743</u>
<u>Tax Credits</u>			<u>Tax Calculations</u>		
1. Credits for dependants	\$ —	\$ 160	Personal income tax before tax credits	\$23,493	\$36,101
2. Dividend tax credits	619	—	Less: total tax credits	624	9,299
3. Refundable credits for corporation income tax	—	9,135	Personal income tax including old age security tax	\$22,869	\$26,802
4. Other tax credits	4	4	Corporation income tax	6,997	9,135
Total tax credits	<u>\$ 624</u>	<u>\$9,299</u>	Taxes on gifts and bequests received	2,254	—
			Total direct taxes	<u>\$32,120</u>	<u>\$35,937</u>

Note: Some columns do not add to totals due to rounding.

TABLE B-8

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 6

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ 32	\$ 32	1. Wages and salaries	\$2,775	\$2,775
2. Retirement savings	55	55	2. Employment expense deductions	—	(110)
3. Net medical expenses	6	5	3. Professional income	3	3
4. Charitable donations	21	6	4. Commission income	19	19
5. Standard deductions	88	48	5. Attributable benefits	—	183
6. Alimony paid	17	17	6. Farming and fishing income	59	59
7. Other deductions	14	1	7. Dividends	4	4
Total deductions	\$ 233	\$164	8. Other corporate income	—	14
Family exemptions	1,000	—	9. Capital gains on shares	—	4
Total deductions and family exemptions	<u>\$1,233</u>	<u>\$164</u>	10. Unincorporated business income	355	372
			11. Net rental income	21	21
			12. Other Canadian investment income	23	96
			13. Non-business capital gains	—	24
			14. Foreign investment income	—	—
			15. Deductions from investment income	—	—
			16. Gifts and bequests	—	31
			17. Transfer payments	—	—
			18. Alimony received	—	—
			19. Miscellaneous income	5	5
			Total income	\$3,263	\$3,500
			Less: total deductions and family exemptions	<u>1,233</u>	<u>164</u>
			Taxable income	<u>\$2,030</u>	<u>\$3,336</u>
<u>Tax Credits</u>			<u>Tax Calculation</u>		
1. Credits for dependants	\$—	\$—	Personal income tax before tax credits	\$316	\$372
2. Dividend tax credits	1	—	Less: total tax credits	<u>1</u>	<u>23</u>
3. Refundable credits for corporation income tax	—	9	Personal income tax including old age security tax	\$316	\$350
4. Other tax credits	—	14	Corporation income tax	6	9
Total tax credits	<u>\$ 1</u>	<u>\$23</u>	Taxes on gifts and bequests received	<u>2</u>	<u>—</u>
			Total direct taxes	<u>\$324</u>	<u>\$358</u>

Note: Some columns do not add to totals due to rounding.

TABLE B-9

## CALCULATION OF TAXES FOR THE AVERAGE TAXPAYER IN EXAMPLE GROUP 7

<u>Deductions</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>	<u>Income</u>	<u>Under the Current System</u>	<u>Under the Proposed System</u>
1. Pension contributions	\$ —	\$ —	1. Wages and salaries	\$ 428	\$ 428
2. Retirement savings	—	—	2. Employment expense deductions	—	-5
3. Net medical expenses	4	4	3. Professional income	3	3
4. Charitable donations	10	-9	4. Commission income	1	1
5. Standard deductions	91	50	5. Attributable benefits	—	—
6. Alimony paid	—	—	6. Farming and fishing income	7	7
7. Other deductions	310	—	7. Dividends	18	18
Total deductions	\$ 415	\$44	8. Other corporate income	—	64
Family exemptions	994	—	9. Capital gains on shares	—	18
Total deductions and family exemptions	<u>\$1,409</u>	<u>\$44</u>	10. Unincorporated business income	—	—
			11. Net rental income	2	2
			12. Other Canadians investment income	384	683
			13. Non-business capital gains	—	58
			14. Foreign investment income	—	—
			15. Deductions from investment income	—	—
			16. Gifts and bequests	—	263
			17. Transfer payments	1,149	1,149
			18. Alimony received	—	—
			19. Miscellaneous income	35	35
			Total income	\$2,025	\$2,723
			Less: total deductions and family exemptions	1,409	44
			Taxable income	<u>\$ 615</u>	<u>\$2,679</u>
<u>Tax Credits</u>			<u>Tax Calculation</u>		
1. Credits for dependants	\$—	\$—	Personal income tax before tax credits	\$ 79	\$250
2. Dividend tax credits	—	—	Less: total tax credits	—	41
3. Refundable credit for corporation income tax	—	41	Personal income tax including old age security tax	\$ 79	\$209
4. Other tax credits	—	—	Corporation income tax	30	41
Total tax credits	<u>\$—</u>	<u>\$ 41</u>	Taxes on gifts and bequests received	31	—
			Total direct taxes	<u>\$140</u>	<u>\$250</u>

Note: Some columns do not add to totals due to rounding.



TABLE B-10

CLASSIFICATION OF TAXPAYERS BY  
ESTIMATED COMPREHENSIVE INCOME

<u>Class</u>	<u>Income</u>		
1	Less than \$1,000		
2	\$ 1,000	-	\$ 1,999
3	2,000	-	2,999
4	3,000	-	3,999
5	4,000	-	4,999
6	5,000	-	5,999
7	6,000	-	7,999
8	8,000	-	9,999
9	10,000	-	11,999
10	12,000	-	14,999
11	15,000	-	19,999
12	20,000	-	24,999
13	25,000	-	34,999
14	35,000	-	49,999
15	50,000	-	74,999
16	75,000	-	99,999
17	100,000	-	149,999
18	150,000	-	199,999
19	200,000	-	299,999
20	300,000 or over		

TABLE B-11

SUMMARY DATA FOR AVERAGE TAXPAYERS IN SEVEN EXAMPLE GROUPS  
(dollars)

Example	Income Class	Taxable Income		Personal Income Tax		Total Direct Taxes	
		Current	Proposed	Current	Proposed	Current	Proposed
1	6	3,012.4	5,515.1	521.1	428.8	527.9	437.2
2	10	9,751.0	14,046.5	2,151.8	2,275.0	2,391.8	2,319.4
3	14	26,286.3	38,436.8	9,295.2	9,797.8	10,367.8	10,111.6
4	17	25,359.5	115,413.8	6,431.4	12,770.6	33,565.1	46,027.9
5	16	53,314.5	94,743.3	22,869.4	26,802.2	32,120.0	35,936.7
6	4	2,029.9	3,335.7	315.6	349.6	324.0	358.2
7	3	615.4	2,678.4	78.6	209.9	140.3	250.3

PRORATION OF THE EFFECTS ON TAX  
REVENUES FROM RESIDENT INDIVIDUALS  
OF EACH PROPOSED DIRECT TAX REFORM

The purpose of this appendix is to show the effect of each major direct tax reform that we have recommended on personal income tax revenue and on total direct tax revenues from resident individuals. The proposed reforms are listed in Table C-1. Two reforms are excluded from this analysis because of the difficulty in allocating their effects to specific taxpayers. The two excluded reforms are the definition of the tax unit on a family basis rather than on an individual basis and the allowance of income averaging.

Because of the different marginal tax rates currently applicable to different taxpayers and because of the combined effect of various proposed reforms affecting the tax base upon the top marginal tax rate faced by each taxpayer under the proposed rate schedule, it is possible to allocate a change in tax revenues among the proposed reforms bringing about that change only by adopting an arbitrary means of allocation. Some reforms would, of course, have effects which were independent of the effects of other proposed reforms. The provision of tax credits for working mothers, to take one example, would involve no change in the tax base and hence would be independent of the other proposals.

We adopted the following procedure to allocate a change in taxes among the reforms causing the change. For each taxpayer in the 1966 Taxation Statistics sample, we calculated the change which would occur in personal income tax before tax credits were taken into account and allocated this change among the proposed reforms in proportion to the change in the personal income tax base which would be affected by the reform 1/. Tax credits associated with each proposed reform were then subtracted from



the before-credit tax change allocated to each reform and associated changes in other taxes were added to the resultant change. These calculations were made for each taxpayer; by aggregating the effect of each proposal on all taxpayers we arrived at prorated estimates of the effect on tax revenues of each proposed reform, given that the other recommended reforms were also implemented.

The results of these calculations for the average taxpayer in the seven example groups presented in Appendix B to this Volume are shown in Tables C-2 and C-3; these figures are derived from the amounts shown for each group in Tables B-3 to B-9 in Appendix B. In these and subsequent tables, proposed reforms are referred to by number; descriptions pertaining to each number are provided in Table C-1. As in Appendix B, each change in the tax base is defined in accordance with the assumptions summarized in Appendix A to this Volume.

Taxpayers are classified into twenty standard income classes based on comprehensive base income. The income classification is defined in Table B-10 in Appendix B. The proration of the effects of each reform by type of tax for all residents is shown in Table C-4. Table C-5 shows the effect of each proposed reform on revenues from the personal income tax, prorated by income class. Table C-6 presents the effects of each reform on all direct taxes from resident individuals, again prorated by income class.

A summary of the data obtained for each income class is presented in Table C-7 in a form that is consistent with the data presented in Appendix B. The amounts shown in Tables C-4, C-5 and C-6 can be reconciled to this table. However, to do so it is necessary to adjust the amounts attributed to taxpayers in the tables in this appendix to reflect the credit for corporation taxes allowed to the trustees of Registered Retirement Income Plans (reform 4-1), resulting in an indirect deferment of taxes on income not allocated to taxpayers in the computations shown in Appendix B to this

Volume. This reform was excluded from the amounts shown in Appendix B because, strictly speaking, it would be attributable to retirement income not yet received rather than to any component of a taxpayer's current investment income as defined under the comprehensive tax base.

All figures shown, for example, data in Tables C-2 and C-3, are in dollars; figures shown in Tables C-4 to C-7 are in thousands of dollars. Some figures do not add to totals due to rounding.

#### REFERENCE

- 1/ The calculations and subsequent aggregation of the changes for all taxpayers are described in the listing of subroutine RVTAB2 contained in J. Bossons, A General Income Tax Analyzer, a study published by the Commission.

TABLE C-1

## DEFINITION OF PROPOSED REFORMS BY CATEGORY

1. Changes in tax rates

- 1.1 Lowering the rate schedule for all taxpayers to the proposed schedule for individuals.
- 1.2 Additional reduction in the rate schedule for families.
- 1.3 Use of a tax credit rather than an exemption to allow for the first child in each family.
- 1.4 Use of credits rather than exemptions to allow for additional dependent children.

2. Taxation of the family as a unit

- 2.1 Aggregation of the income of husbands and wives, assuming that income is taxed at the rates of the proposed schedule for individuals a/.
- 2.2 Effect of taxing the aggregated income of husbands and wives under the family rate schedule a/.
- 2.3 Aggregation of income of parents and children a/.
- 2.4 Effect of elimination of taxes on transfers of wealth between members of a family unit.

3. Changes in the taxation of corporate source income

- 3.1 Integration of corporation and personal income taxes.
- 3.2 Widening the corporation tax base.
- 3.3 Taxation of capital gains and allowance of capital losses on corporate shares.
- 3.4 Disallowance of shareholder depletion deductions.

4. Changes in the taxation of other business and property income

- 4.1 Deferment of taxes on the investment income of Registered Retirement Income Plans.
- 4.2 Taxation of capital gains and allowance of capital losses of unincorporated businesses.
- 4.3 Acceleration of capital cost allowances for unincorporated businesses.
- 4.4 Extension of loss carry-over provisions for unincorporated businesses.
- 4.5 Extension of reporting controls to bring unreported interest into the tax base.
- 4.6 Attribution of life insurance policyholder investment income.
- 4.7 Attribution of participating dividends paid by credit unions, co-operatives and mutual life insurance companies.
- 4.8 Taxation of non-business capital gains and allowance of non-business capital losses.

5. Changes in the taxation of employment income

- 5.1 Liberalization of the definition of deductible employment expenses.
- 5.2 Optional standard expense allowance.
- 5.3 Attribution of employee benefits.
- 5.4 Working mother credit.
- 5.5 Deductibility of unemployment insurance.

6. Other changes resulting from adoption of the comprehensive tax base

- 6.1 Inclusion of gifts and bequests.
- 6.2 Inclusion of family allowances and other transfer payments.

7. Changes in concessionary allowances

- 7.1 Elimination of the old age exemption.
- 7.2 Changed definition of medical expenses.
- 7.3 Improvements in the control of charitable donations.
- 7.4 Change in the standard deduction.
- 7.5 Provision of additional educational allowances in the form of a tax credit.
- 7.6 Allowance of credits rather than exemptions for dependants other than dependent children.

## Note:

a/ The first three proposed reforms in the "taxation of the family as a unit" category have no figures listed under them in subsequent tables. They are included here as "reserved" elements of the table and are included on that basis in the RVTAB2 subroutine so that they can be shown, given subsequent allocation of the effects of the family unit definition. The basis for such allocation is described in J. Bossons, A General Income Tax Analyzer.



TABLE C-2

PRORATION OF THE EFFECTS OF THE PROPOSED REFORMS ON TAX REVENUES  
FROM SEVEN EXAMPLE GROUPS: AVERAGE CHANGES IN PERSONAL INCOME TAXES IN EACH EXAMPLE GROUP  
(dollars)

	Example Groups						
	1	2	3	4	5	6	7
1. Reform Category 1 — Changes in tax rates							
Reform ( 1, 1)	-14.	-29.	-1700.	-1579.	-4874.	-5.	-2.
Reform ( 1, 2)	-48.	-315.	-933.	-1031.	-1021.	0.	0.
Reform ( 1, 3)	-43.	0.	5.	5.	32.	0.	0.
Reform ( 1, 4)	0.	0.	202.	180.	72.	0.	0.
Total in Class	-106.	-344.	-2426.	-2425.	-5791.	-5.	-2.
2. Reform Category 2 — Taxation of the family as a unit							
Reform ( 2, 1)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 4)	0.	0.	0.	0.	0.	0.	0.
Total in Class	0.	0.	0.	0.	0.	0.	0.
3. Reform Category 3 — Changes in taxation of corporate source income							
Reform ( 3, 1)	-5.	-22.	-96.	-5962.	-1502.	-5.	-27.
Reform ( 3, 2)	-0.	-2.	-6.	-245.	-47.	-0.	-2.
Reform ( 3, 3)	1.	5.	47.	5990.	1693.	1.	3.
Reform ( 3, 4)	0.	0.	0.	361.	265.	0.	0.
Total in Class	-4.	-19.	-55.	-144.	409.	-4.	-27.
4. Reform Category 4 — Changes in taxation of other property income							
Reform ( 4, 1)	0.	0.	0.	0.	0.	0.	0.
Reform ( 4, 2)	0.	-0.	52.	0.	6.	6.	0.
Reform ( 4, 3)	-0.	-0.	-18.	-14.	-28.	-2.	-0.
Reform ( 4, 4)	-0.	-0.	-0.	-0.	-0.	-0.	-0.
Reform ( 4, 5)	1.	80.	58.	456.	469.	3.	43.
Reform ( 4, 6)	12.	37.	135.	356.	330.	7.	4.
Reform ( 4, 7)	7.	21.	75.	198.	184.	4.	2.
Reform ( 4, 8)	-2.	17.	19.	1684.	685.	5.	9.
Total in Class	17.	154.	322.	2680.	1647.	23.	58.
5. Reform Category 5 — Changes in taxation of employment income							
Reform ( 5, 1)	-13.	-70.	-0.	-41.	-704.	-0.	-0.
Reform ( 5, 2)	-17.	-10.	-16.	-45.	-0.	-17.	-0.
Reform ( 5, 3)	22.	70.	237.	57.	704.	37.	0.
Reform ( 5, 4)	0.	0.	0.	0.	0.	0.	0.
Reform ( 5, 5)	-6.	-8.	-7.	-15.	-15.	-5.	-1.
Total in Class	-15.	-17.	214.	-43.	-15.	15.	-1.
6. Reform Category 6 — Other aspects of the comprehensive base							
Reform ( 6, 1)	6.	369.	2277.	5804.	7602.	6.	43.
Reform ( 6, 2)	15.	0.	168.	184.	76.	0.	0.
Total in Class	21.	369.	2445.	5988.	7678.	6.	43.
7. Reform Category 7 — Changes in concessionary allowances							
Reform ( 7, 1)	0.	0.	0.	0.	0.	0.	51.
Reform ( 7, 2)	0.	1.	0.	-0.	-0.	0.	-0.
Reform ( 7, 3)	3.	5.	6.	3.	8.	3.	3.
Reform ( 7, 4)	5.	7.	1.	3.	8.	8.	7.
Reform ( 7, 5)	-14.	-30.	-1.	0.	0.	-11.	0.
Reform ( 7, 6)	0.	0.	0.	0.	0.	0.	0.
Total in Class	-6.	-18.	6.	6.	17.	-0.	60.
Undistributed Amounts	-0.	-1.	-4.	-11.	-10.	-0.	-0.
Total Changes	-92.	123.	503.	6339.	3933.	34.	131.
Current Total	521.	2152.	9295.	6431.	22869.	316.	79.
New Total	429.	2275.	9798.	12771.	26802.	350.	210.
Percentage Change	-17.7	5.7	5.4	98.6	17.2	10.8	167.

TABLE C-3

PRORATION OF THE EFFECTS OF THE PROPOSED REFORMS ON TAX REVENUES  
FROM SEVEN EXAMPLE GROUPS: AVERAGE CHANGES IN ALL DIRECT TAXES IN EACH EXAMPLE GROUP  
(dollars)

	Example Groups						
	1	2	3	4	5	6	7
1. Reform Category 1 – Changes in tax rates							
Reform ( 1, 1)	-14.	-29.	-1700.	-1579.	-4874.	-5.	-2.
Reform ( 1, 2)	-48.	-315.	-933.	-1031.	-1021.	0.	0.
Reform ( 1, 3)	-43.	0.	5.	5.	32.	0.	0.
Reform ( 1, 4)	0.	0.	202.	180.	72.	0.	0.
Total in Class	-106.	-344.	-2426.	-2425.	-5791.	-5.	-2.
2. Reform Category 2 – Taxation of the family as a unit							
Reform ( 2, 1)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 4)	-0.	-114.	-458.	-913.	-1240.	-1.	-17.
Total in Class	-0.	-114.	-458.	-913.	-1240.	-1.	-17.
3. Reform Category 3 – Changes in taxation of corporate source income							
Reform ( 3, 1)	-3.	-15.	-49.	-973.	-132.	-3.	-21.
Reform ( 3, 2)	0.	2.	20.	2549.	721.	0.	1.
Reform ( 3, 3)	1.	5.	47.	5990.	1693.	1.	3.
Reform ( 3, 4)	0.	0.	0.	361.	265.	0.	0.
Total in Class	-2.	-8.	18.	7928.	2547.	2.	-17.
4. Reform Category 4 – Changes in taxation of other property income							
Reform ( 4, 1)	-11.	-31.	-107.	-29.	-65.	-3.	0.
Reform ( 4, 2)	0.	-0.	52.	0.	6.	6.	0.
Reform ( 4, 3)	-0.	-0.	-18.	-14.	-28.	-2.	-0.
Reform ( 4, 4)	-0.	-0.	-0.	-0.	-0.	-0.	-0.
Reform ( 4, 5)	1.	80.	58.	456.	469.	3.	43.
Reform ( 4, 6)	12.	37.	135.	356.	330.	7.	4.
Reform ( 4, 7)	7.	21.	75.	198.	184.	4.	2.
Reform ( 4, 8)	-2.	17.	19.	1684.	685.	5.	9.
Total in Class	6.	123.	215.	2651.	1582.	20.	58.
5. Reform Category 5 – Changes in taxation of employment income							
Reform ( 5, 1)	-13.	-70.	-0.	-41.	-704.	-0.	-0.
Reform ( 5, 2)	-17.	-10.	-16.	-45.	-0.	-17.	-0.
Reform ( 5, 3)	22.	70.	237.	57.	704.	37.	0.
Reform ( 5, 4)	0.	0.	0.	0.	0.	0.	0.
Reform ( 5, 5)	-6.	-8.	-7.	-15.	-15.	-5.	-1.
Total in Class	-15.	-17.	214.	-43.	-15.	15.	-1.
6. Reform Category 6 – Other aspects of the comprehensive base							
Reform ( 6, 1)	6.	276.	1902.	5057.	6588.	5.	29.
Reform ( 6, 2)	15.	0.	168.	184.	76.	0.	0.
Total in Class	21.	276.	2071.	5241.	6663.	5.	29.
7. Reform Category 7 – Changes in concessionary allowances							
Reform ( 7, 1)	0.	0.	0.	0.	0.	0.	51.
Reform ( 7, 2)	0.	1.	0.	-0.	-0.	0.	-0.
Reform ( 7, 3)	3.	5.	6.	3.	8.	3.	3.
Reform ( 7, 4)	5.	7.	1.	3.	8.	8.	7.
Reform ( 7, 5)	-14.	-30.	-1.	0.	0.	-11.	0.
Reform ( 7, 6)	0.	0.	0.	0.	0.	0.	0.
Total in Class	-6.	-18.	6.	6.	17.	-0.	60.
Undistributed Amounts	-0.	-1.	-4.	-11.	-10.	-0.	-0.
Total Changes	-102.	-103.	-363.	12434.	3752.	32.	110.
Current Total	528.	2392.	10368.	33565.	32120.	324.	140.
New Total	426.	2289.	10005.	45999.	35872.	356.	250.
Percentage Change	-19.3	-4.3	3.5	37.0	11.7	9.7	78.4

TABLE C-4

PRORATION OF THE EFFECTS OF THE PROPOSED REFORMS ON TAX REVENUES  
FROM ALL RESIDENTS: TOTAL CHANGES IN THE TAX BASES AND TAXES  
(thousands of dollars)

REFORM	Personal Income Tax		Corporation Income Tax		Gift Tax
	Base	Tax	Base	Tax	
1. Reform Category 1 – Changes in tax rates					
Reform ( 1, 1)	6662961.	-113326.	0.	0.	0.
Reform ( 1, 2)	2649456.	-203521.	0.	0.	0.
Reform ( 1, 3)	896900.	-72211.	0.	0.	0.
Reform ( 1, 4)	1197355.	14464.	0.	0.	0.
Total in Class	11406672.	-374594.	0.	0.	0.
2. Reform Category 2 – Taxation of the family as a unit					
Reform ( 2, 1)	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.
Reform ( 2, 4)	0.	0.	0.	0.	-78653.
Total in Class	0.	0.	0.	0.	-78653.
3. Reform Category 3 – Changes in Taxation of corporate source income					
Reform ( 3, 1)	1533660.	-363433.	0.	170984.	0.
Reform ( 3, 2)	179979.	-27243.	179983.	89991.	0.
Reform ( 3, 3)	450656.	155189.	0.	0.	0.
Reform ( 3, 4)	4317.	1998.	0.	0.	0.
Total in Class	2188612.	-233489.	179983.	260975.	0.
4. Reform Category 4 – Changes in taxation of other property income					
Reform ( 4, 1)	0.	0.	0.	-45017.	0.
Reform ( 4, 2)	95016.	18987.	0.	0.	0.
Reform ( 4, 3)	-49177.	-7666.	0.	0.	0.
Reform ( 4, 4)	-6567.	-876.	0.	0.	0.
Reform ( 4, 5)	376613.	83876.	0.	0.	0.
Reform ( 4, 6)	312376.	63497.	0.	0.	0.
Reform ( 4, 7)	174349.	35440.	0.	0.	0.
Reform ( 4, 8)	249814.	68914.	0.	0.	0.
Total in Class	1152423.	262172.	0.	-45017.	0.
5. Reform Category 5 – Changes in taxation of employment income					
Reform ( 5, 1)	-197848.	-46130.	0.	0.	0.
Reform ( 5, 2)	-423827.	-71019.	0.	0.	0.
Reform ( 5, 3)	673610.	131705.	0.	0.	0.
Reform ( 5, 4)	0.	-41832.	0.	0.	0.
Reform ( 5, 5)	-150085.	-25384.	0.	0.	0.
Total in Class	-98150.	-52660.	0.	0.	0.
6. Reform Category 6 – Other aspects of comprehensive base					
Reform ( 6, 1)	1199740.	353483.	0.	0.	-64352.
Reform ( 6, 2)	471254.	67998.	0.	0.	0.
Total in Class	1670994.	421482.	0.	0.	-64352.
7. Reform Category 7 – Changes in concessionary allowances					
Reform ( 7, 1)	141610.	23614.	0.	0.	0.
Reform ( 7, 2)	7356.	1298.	0.	0.	0.
Reform ( 7, 3)	126975.	14419.	0.	0.	0.
Reform ( 7, 4)	228286.	30470.	0.	0.	0.
Reform ( 7, 5)	110336.	-71935.	0.	0.	0.
Reform ( 7, 6)	239318.	3106.	0.	0.	0.
Total in Class	853881.	971.	0.	0.	0.
Undistributed Amounts	0.	-192.	0.	0.	0.
Total Changes	17154431.	23689.	179983.	215958.	-143006.
Current Total	13226005.	2676014.	1961812.	809923.	143006.
New Total	30380436.	2699702.	2141795.	1025880.	0.
Percentage Change	129.7	0.9	9.2	26.7	-100.0

Note: Taxpayers are not aggregated into family units.  
All base changes are prorated together.



TABLE C-5

PRORATION OF THE EFFECTS OF THE PROPOSED REFORMS ON TAX REVENUES  
FROM ALL RESIDENTS: CHANGES IN PERSONAL INCOME TAXES BY INCOME CLASS  
(thousands of dollars)

REFORM	Income Classes									
	1	2	3	4	5	6	7	8	9	10
<b>1. Reform Category 1 – Changes in Tax Rates</b>										
Reform ( 1, 1)	-701.	-2440.	-40.	-3879.	-5318.	-1773.	4778.	5902.	2062.	749.
Reform ( 1, 2)	-44.	-485.	-3586.	-10672.	-20714.	-23468.	-38795.	-21926.	-11118.	-14100.
Reform ( 1, 3)	1.	-517.	-2962.	-11508.	-19066.	-16214.	-15097.	-4557.	-1269.	-1131.
Reform ( 1, 4)	0.	0.	20.	36.	-804.	1096.	3798.	2209.	971.	1375.
Total in Class	-744.	-3441.	-6568.	-26022.	-45902.	-40359.	-45317.	-18372.	-9354.	-13108.
<b>2. Reform Category 2 – Taxation of the family as unit</b>										
Reform ( 2, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 4)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Total in Class	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
<b>3. Reform Category 3 – Changes in taxation of corporate source income</b>										
Reform ( 3, 1)	-3202.	-5028.	-10733.	-12169.	-17806.	-17641.	-27514.	-24660.	-18900.	-25462.
Reform ( 3, 2)	-294.	-451.	-945.	-1082.	-1572.	-1554.	-2432.	-2174.	-1662.	-2213.
Reform ( 3, 3)	0.	288.	941.	1401.	2451.	2723.	4685.	4610.	3769.	5828.
Reform ( 3, 4)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Total in Class	-3496.	-5190.	-10736.	-11849.	-16926.	-16472.	-25260.	-22224.	-16793.	-21846.
<b>4. Reform Category 4 – Changes in taxation of other property income</b>										
Reform ( 4, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 4, 2)	0.	198.	579.	993.	1686.	1674.	2701.	1901.	1473.	1486.
Reform ( 4, 3)	-0.	-141.	-325.	-567.	-873.	-792.	-1103.	-683.	-414.	-510.
Reform ( 4, 4)	-0.	-17.	-37.	-46.	-50.	-59.	-92.	-39.	-51.	-68.
Reform ( 4, 5)	0.	997.	3680.	5173.	7184.	7572.	11159.	7427.	4849.	5867.
Reform ( 4, 6)	0.	1415.	3710.	6168.	8762.	8410.	10054.	4711.	2132.	2631.
Reform ( 4, 7)	0.	790.	2070.	3443.	4890.	4694.	5612.	2629.	1190.	1468.
Reform ( 4, 8)	0.	421.	1560.	1919.	3044.	3312.	5488.	4224.	3025.	3866.
Total in Class	0.	3663.	11237.	17083.	24643.	24810.	33818.	20171.	12203.	14741.
<b>5. Reform Category 5 – Changes in taxation of employment income</b>										
Reform ( 5, 1)	-0.	-0.	-0.	-14.	-2814.	-6815.	-11858.	-6483.	-2570.	-3322.
Reform ( 5, 2)	-0.	-3478.	-8594.	-14433.	-17171.	-12096.	-9833.	-2693.	-825.	-662.
Reform ( 5, 3)	0.	679.	4749.	12520.	18666.	18035.	22823.	11599.	6431.	7289.
Reform ( 5, 4)	0.	-8465.	-14227.	-11053.	-4875.	-1631.	-1003.	-230.	-109.	-102.
Reform ( 5, 5)	-0.	-1312.	-3009.	-4509.	-5214.	-4119.	-3900.	-1338.	-459.	-469.
Total in Class	-0.	-12576.	-21081.	-17488.	-11407.	-6625.	-3772.	855.	2468.	2733.
<b>6. Reform Category 6 – Other aspects of comprehensive base</b>										
Reform ( 6, 1)	0.	1577.	5177.	7718.	10771.	10998.	17885.	14743.	15113.	25198.
Reform ( 6, 2)	0.	39.	784.	4340.	13543.	15449.	17399.	6361.	2171.	2414.
Total in Class	0.	1616.	5961.	12058.	24315.	26447.	35283.	21104.	17284.	27613.
<b>7. Reform Category 7 – Changes in concessionary allowances</b>										
Reform ( 7, 1)	0.	905.	3858.	3618.	3606.	2723.	2617.	1350.	840.	861.
Reform ( 7, 2)	0.	99.	96.	108.	141.	162.	265.	125.	41.	54.
Reform ( 7, 3)	0.	1492.	2225.	2441.	2575.	1932.	1801.	669.	257.	281.
Reform ( 7, 4)	0.	3399.	5141.	5642.	5643.	4180.	3671.	1202.	448.	396.
Reform ( 7, 5)	0.	-6600.	-7198.	-7360.	-9268.	-9980.	-16070.	-7032.	-2116.	-2225.
Reform ( 7, 6)	0.	-13.	-22.	-530.	-298.	282.	806.	469.	225.	358.
Total in Class	0.	-718.	4098.	3920.	2399.	-701.	-6909.	-3217.	-306.	-275.
Undistributed Amounts	-79.	-11.	-20.	-14.	-3.	-3.	-53.	-5.	-4.	-1.
Total Changes	-4319.	-16657.	-17110.	-22313.	-22882.	-12903.	-12210.	-1688.	5499.	9857.
Current Total	823.	31017.	128520.	234264.	325685.	331869.	434749.	222252.	100600.	126257.
New Total	-3496.	14360.	111411.	211952.	302803.	318965.	422539.	220564.	106099.	136114.
Percentage Change	-524.9	-53.7	-13.3	-9.5	-7.0	-3.9	-2.8	-0.8	5.5	7.8

TABLE C-5 (Continued)

REFORM	Income Classes									
	11	12	13	14	15	16	17	18	19	20
<b>1. Reform Category 1 – Changes in tax rates</b>										
Reform ( 1, 1)	-4078.	-7146.	-17160.	-19213.	-18471.	-11069.	-11511.	-5918.	-6155.	-11945.
Reform ( 1, 2)	-16802.	-9903.	-13520.	-9451.	-5077.	-1911.	-1162.	-403.	-212.	-172.
Reform ( 1, 3)	-625.	-97.	117.	245.	221.	113.	69.	32.	19.	13.
Reform ( 1, 4)	1469.	982.	1251.	938.	614.	232.	177.	47.	32.	21.
Total in Class	-20036.	-16163.	-29312.	-27481.	-22714.	-12635.	-12427.	-6242.	-6316.	-12083.
<b>2. Reform Category 2 – Taxation of the family as a unit</b>										
Reform ( 2, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 4)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Total in Class	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
<b>3. Reform Category 3 – Changes in taxation of corporate source income</b>										
Reform ( 3, 1)	-34330.	-22942.	-32712.	-34490.	-28512.	-10943.	-12575.	-6051.	-6130.	-11634.
Reform ( 3, 2)	-2916.	-1908.	-2582.	-2494.	-1796.	-549.	-451.	-113.	-48.	-5.
Reform ( 3, 3)	8984.	7042.	12394.	16992.	18882.	9720.	14436.	8735.	10109.	21198.
Reform ( 3, 4)	0.	13.	42.	64.	209.	197.	342.	269.	253.	608.
Total in Class	-28263.	-17795.	-22859.	-19928.	-11217.	-1575.	1751.	2840.	4184.	10167.
<b>4. Reform Category 4 – Changes in taxation of other property income</b>										
Reform ( 4, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 4, 2)	2069.	1146.	1274.	706.	407.	185.	283.	85.	92.	50.
Reform ( 4, 3)	-574.	-344.	-418.	-327.	-237.	-111.	-124.	-51.	-32.	-40.
Reform ( 4, 4)	-62.	-45.	-48.	-56.	-68.	-34.	-25.	-55.	-12.	-13.
Reform ( 4, 5)	6856.	4259.	5682.	5100.	3908.	1554.	1386.	521.	400.	302.
Reform ( 4, 6)	2854.	1739.	2466.	2278.	1976.	1034.	1135.	583.	573.	867.
Reform ( 4, 7)	1593.	971.	1376.	1271.	1103.	577.	633.	325.	320.	484.
Reform ( 4, 8)	5517.	3628.	5914.	6065.	6339.	3455.	4491.	2301.	1956.	2387.
Total in Class	18252.	11353.	16247.	15037.	13429.	6660.	7780.	3710.	3299.	4036.
<b>5. Reform Category 5 – Changes in taxation of employment income</b>										
Reform ( 5, 1)	-3164.	-1692.	-2094.	-1989.	-1643.	-690.	-540.	-193.	-142.	-108.
Reform ( 5, 2)	-398.	-192.	-232.	-183.	-122.	-46.	-38.	-11.	-7.	-7.
Reform ( 5, 3)	8720.	4788.	5863.	4223.	2769.	1145.	820.	262.	193.	130.
Reform ( 5, 4)	-56.	-28.	-26.	-11.	-9.	-3.	-2.	-0.	-1.	0.
Reform ( 5, 5)	-365.	-177.	-195.	-142.	-91.	-34.	-29.	-10.	-7.	-5.
Total in Class	4738.	2699.	3317.	1897.	904.	372.	211.	48.	37.	10.
<b>6. Reform Category 6 – Other aspects of comprehensive base</b>										
Reform ( 6, 1)	30206.	19527.	30454.	37351.	33609.	21279.	24278.	12877.	13679.	21042.
Reform ( 6, 2)	2007.	971.	1147.	703.	386.	143.	90.	25.	15.	11.
Total in Class	32214.	20497.	31601.	38054.	33995.	21422.	24368.	12902.	13694.	21053.
<b>7. Reform Category 7 – Changes in concessionary allowances</b>										
Reform ( 7, 1)	910.	486.	531.	482.	363.	136.	159.	63.	56.	50.
Reform ( 7, 2)	36.	36.	38.	27.	35.	9.	8.	12.	3.	3.
Reform ( 7, 3)	251.	124.	138.	101.	66.	25.	22.	9.	7.	5.
Reform ( 7, 4)	324.	138.	127.	82.	46.	14.	11.	3.	2.	1.
Reform ( 7, 5)	-1391.	-1114.	-719.	-514.	-268.	-71.	-38.	34.	-12.	6.
Reform ( 7, 6)	406.	270.	402.	326.	226.	87.	66.	24.	14.	8.
Total in Class	537.	-59.	516.	504.	468.	199.	227.	144.	69.	74.
Undistributed Amounts	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.
Total Changes	7443.	533.	-490.	8083.	14865.	14443.	21910.	13402.	14968.	23258.
Current Total	138895.	86455.	125079.	110423.	91665.	50834.	49692.	24307.	24125.	38503.
New Total	146338.	86987.	124589.	118507.	106530.	65277.	71602.	37710.	39093.	61760.
Percentage Change	5.4	0.6	-0.4	7.3	16.2	28.4	44.1	55.1	62.0	60.4

Note: Taxpayers are not aggregated into family units.  
All base changes are prorated together.

TABLE C-6

PRORATION OF THE EFFECTS OF THE PROPOSED REFORMS ON TAX REVENUES  
FROM ALL RESIDENTS: CHANGES IN ALL DIRECT TAXES BY INCOME CLASS  
(thousands of dollars)

REFORM	Income Classes									
	1	2	3	4	5	6	7	8	9	10
1. Reform Category 1 — Changes in Tax Rates										
Reform (1, 1)	-701.	-2440.	-40.	-3879.	-5318.	-1773.	4778.	5902.	2062.	749.
Reform (1, 2)	-44.	-485.	-3586.	-10672.	-20714.	-23468.	-38795.	-21926.	-11118.	-14100.
Reform (1, 3)	1.	-517.	-2962.	-11508.	-19066.	-16214.	-15097.	-4557.	-1269.	-1131.
Reform (1, 4)	0.	0.	20.	36.	-804.	1096.	3798.	2209.	971.	1375.
Total in Class	-744.	-3441.	-6568.	-26022.	-45902.	-40359.	-45317.	-18372.	-9354.	-13108.
2. Reform Category 2 — Taxation of the family as a unit										
Reform (2, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform (2, 2)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform (2, 3)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform (2, 4)	-287.	-780.	-1956.	-2136.	-2599.	-2548.	-4570.	-4183.	-4655.	-7503.
Total in Class	-287.	-780.	-1956.	-2136.	-2599.	-2548.	-4570.	-4183.	-4655.	-7503.
3. Reform Category 3 — Changes in taxation of corporate source income										
Reform (3, 1)	-2625.	-3923.	-8161.	-8979.	-12855.	-12519.	-19178.	-16888.	-12773.	-16690.
Reform (3, 2)	0.	111.	363.	540.	945.	1050.	1806.	1778.	1453.	2247.
Reform (3, 3)	0.	288.	941.	1401.	2451.	2723.	4685.	4610.	3769.	5828.
Reform (3, 4)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Total in Class	-2625.	-3524.	-6857.	-7037.	-9459.	-8746.	-12687.	-10500.	-7551.	-8614.
4. Reform Category 4 — Changes in taxation of other property income										
Reform (4, 1)	-77.	-459.	-1694.	-4361.	-7642.	-7312.	-8889.	-4172.	-1653.	-2050.
Reform (4, 2)	0.	198.	579.	993.	1686.	1674.	2701.	1901.	1473.	1486.
Reform (4, 3)	-0.	-141.	-325.	-567.	-873.	-792.	-1103.	-683.	-414.	-510.
Reform (4, 4)	-0.	-17.	-37.	-46.	-50.	-59.	-92.	-39.	-51.	-68.
Reform (4, 5)	0.	997.	3680.	5173.	7184.	7572.	11159.	7427.	4849.	5867.
Reform (4, 6)	0.	1415.	3710.	6168.	8762.	8410.	10054.	4711.	2132.	2631.
Reform (4, 7)	0.	790.	2070.	3443.	4890.	4694.	5612.	2629.	1190.	1468.
Reform (4, 8)	0.	421.	1560.	1919.	3044.	3312.	5488.	4224.	3025.	3866.
Total in Class	-77.	3204.	9543.	12722.	17001.	17499.	24929.	15998.	10550.	12691.
5. Reform Category 5 — Changes in taxation of employment income										
Reform (5, 1)	-0.	-0.	-0.	-14.	-2814.	-6815.	-11858.	-6483.	-2570.	-3322.
Reform (5, 2)	-0.	-3478.	-8594.	-14433.	-17171.	-12096.	-9833.	-2693.	-825.	-662.
Reform (5, 3)	0.	679.	4749.	12520.	18666.	18035.	22823.	11599.	6431.	7289.
Reform (5, 4)	0.	-8465.	-14227.	-11053.	-4875.	-1631.	-1003.	-230.	-109.	-102.
Reform (5, 5)	-0.	-1312.	-3009.	-4509.	-5214.	-4119.	-3900.	-1338.	-459.	-469.
Total in Class	-0.	-12576.	-21081.	-17488.	-11407.	-6625.	-3772.	855.	2468.	2733.
6. Reform Category 6 — Other aspects of comprehensive base										
Reform (6, 1)	-235.	939.	3576.	5970.	8645.	8913.	14145.	11321.	11304.	19059.
Reform (6, 2)	0.	39.	784.	4340.	13543.	15449.	17399.	6361.	2171.	2414.
Total in Class	-235.	978.	4361.	10310.	22188.	24362.	31544.	17682.	13475.	21473.
7. Reform Category 7 — Changes in concessionary allowances										
Reform (7, 1)	0.	905.	3858.	3618.	3606.	2723.	2617.	1350.	840.	861.
Reform (7, 2)	0.	99.	96.	108.	141.	162.	265.	125.	41.	54.
Reform (7, 3)	0.	1492.	2223.	2441.	2575.	1932.	1801.	669.	257.	281.
Reform (7, 4)	0.	3399.	5141.	5642.	5643.	4180.	3671.	1202.	448.	396.
Reform (7, 5)	0.	-6600.	-7198.	-7360.	-9268.	-9980.	-16070.	-7032.	-2116.	-2225.
Reform (7, 6)	0.	-13.	-22.	-530.	-298.	282.	806.	469.	225.	358.
Total in Class	0.	-718.	4098.	3920.	2399.	-701.	-6909.	-3217.	-306.	-275.
Undistributed amounts	-79.	-11.	-20.	-14.	-3.	-3.	-53.	-5.	-4.	-1.
Total Changes	-4045.	-16868.	-18481.	-25746.	-27782.	-17122.	-16835.	-1742.	4625.	7397.
Current Total	3969.	37453.	143759.	252640.	352896.	359768.	480921.	265161.	136896.	179745.
New Total	-77.	20586.	125278.	226894.	325114.	342646.	464086.	263420.	141521.	187142.
Percentage Change	-101.9	-45.0	-12.9	-10.2	-7.9	-4.8	-3.5	-0.7	3.4	4.1



TABLE C-6 (Continued)

REFORM	Income Classes									
	11	12	13	14	15	16	17	18	19	20
1. Reform Category 1 — Changes in tax rates										
Reform ( 1, 1)	-4078.	-7146.	-17160.	-19213.	-18471.	-11069.	-11511.	-5918.	-6155.	-11945.
Reform ( 1, 2)	-16802.	-9903.	-13520.	-9451.	-5077.	-1911.	-1162.	-403.	-212.	-172.
Reform ( 1, 3)	-625.	-97.	117.	245.	221.	113.	69.	32.	19.	13.
Reform ( 1, 4)	1469.	982.	1251.	938.	614.	232.	177.	47.	32.	21.
Total in Class	-20036.	-16163.	-29312.	-27481.	-22714.	-12635.	-12427.	-6242.	-6316.	-12083.
2. Reform Category 2 — Taxation of the family as a unit										
Reform ( 2, 1)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 2)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 3)	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
Reform ( 2, 4)	-8235.	-4820.	-6715.	-7347.	-5952.	-3509.	-3791.	-1939.	-2036.	-3090.
Total in Class	-8235.	-4820.	-6715.	-7347.	-5952.	-3509.	-3791.	-1939.	-2036.	-3090.
3. Reform Category 3 — Changes in taxation of corporate source income										
Reform ( 3, 1)	-21782.	-13849.	-18242.	-16807.	-10737.	-2549.	-800.	788.	1637.	4481.
Reform ( 3, 2)	3464.	2715.	4788.	6745.	7527.	4037.	6136.	3718.	4302.	9022.
Reform ( 3, 3)	8984.	7042.	12394.	16992.	18882.	9720.	14436.	8735.	10109.	21198.
Reform ( 3, 4)	0.	13.	42.	64.	209.	197.	342.	269.	253.	608.
Total in Class	-9334.	-4078.	-1018.	6994.	15881.	11405.	20113.	13509.	16302.	35309.
4. Reform Category 4 — Changes in taxation of other property income										
Reform ( 4, 1)	-1990.	-1096.	-1429.	-1043.	-620.	-258.	-163.	-50.	-36.	-23.
Reform ( 4, 2)	2069.	1146.	1274.	706.	407.	185.	283.	85.	92.	50.
Reform ( 4, 3)	-574.	-344.	-418.	-327.	-237.	-111.	-124.	-51.	-32.	-40.
Reform ( 4, 4)	-62.	-45.	-48.	-56.	-68.	-34.	-25.	-55.	-12.	-13.
Reform ( 4, 5)	6856.	4259.	5682.	5100.	3908.	1554.	1386.	521.	400.	302.
Reform ( 4, 6)	2854.	1739.	2466.	2278.	1976.	1034.	1135.	583.	573.	867.
Reform ( 4, 7)	1593.	971.	1376.	1271.	1103.	577.	633.	325.	320.	484.
Reform ( 4, 8)	5517.	3628.	5914.	6065.	6339.	3455.	4491.	2301.	1956.	2387.
Total in Class	16263.	10257.	14818.	13994.	12808.	6402.	7617.	3659.	3263.	4013.
5. Reform Category 5 — Changes in taxation of employment income										
Reform ( 5, 1)	-3164.	-1692.	-2094.	-1989.	-1643.	-690.	-540.	-193.	-142.	-108.
Reform ( 5, 2)	-398.	-192.	-232.	-183.	-122.	-46.	-38.	-11.	-7.	-7.
Reform ( 5, 3)	8720.	4788.	5863.	4223.	2769.	1145.	820.	262.	193.	130.
Reform ( 5, 4)	-56.	-28.	-26.	-11.	-9.	-3.	-2.	-0.	-1.	0.
Reform ( 5, 5)	-365.	-177.	-195.	-142.	-91.	-34.	-29.	-10.	-7.	-5.
Total in Class	4738.	2699.	3317.	1897.	904.	372.	211.	48.	37.	10.
6. Reform Category 6 — Other aspects of comprehensive base										
Reform ( 6, 1)	23468.	15583.	24960.	31340.	28739.	18408.	21177.	11291.	12013.	18514.
Reform ( 6, 2)	2007.	971.	1147.	703.	386.	143.	90.	25.	15.	11.
Total in Class	25476.	16553.	26107.	32043.	29125.	18552.	21267.	11316.	12028.	18525.
7. Reform Category 7 — Changes in concessionary allowances										
Reform ( 7, 1)	910.	486.	531.	482.	363.	136.	159.	63.	56.	50.
Reform ( 7, 2)	36.	36.	38.	27.	35.	9.	8.	12.	3.	3.
Reform ( 7, 3)	251.	124.	138.	101.	66.	25.	22.	9.	7.	5.
Reform ( 7, 4)	324.	138.	127.	82.	46.	14.	11.	3.	2.	1.
Reform ( 7, 5)	-1391.	-1114.	-719.	-514.	-268.	-71.	-38.	34.	-12.	6.
Reform ( 7, 6)	406.	270.	402.	326.	226.	87.	66.	24.	14.	8.
Total in Class	537.	-59.	516.	504.	468.	199.	227.	144.	69.	74.
Undistributed Amounts	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.	-0.
Total Changes	9408.	4389.	7713.	20605.	30520.	20786.	33217.	20496.	23347.	42759.
Current Total	210868.	136525.	203151.	206802.	186333.	98815.	116608.	62749.	67482.	126401.
New Total	220277.	140914.	210864.	227407.	216853.	119601.	149825.	83245.	90829.	169159.
Percentage Change	4.5	3.2	3.8	10.0	16.4	21.0	28.5	32.7	34.6	33.8

Note: Taxpayers are not aggregated into family units.  
All base changes are prorated together.

TABLE C-7

SUMMARY OF TAX CHANGES FOR  
ALL RESIDENTS  
(thousands of dollars where applicable)

Income Class	Number of Data Records	Number of Tax Units	Taxable Income		Personal Income Tax		Total Direct Taxes	
			Current	Proposed	Current	Proposed	Current	Proposed
1	943	698227	-498944.2	316291.9	822.9	-3496.1	3968.9	0.0
2	1585	919539	76390.6	1337346.6	31016.9	14359.9	37453.2	21044.3
3	1568	1076928	817831.6	2630959.7	128520.3	111410.7	143759.2	126971.7
4	1495	1072471	1480668.0	3665745.4	234264.4	211951.6	252639.7	231254.7
5	1289	1001470	2001519.9	4402158.3	325685.1	302802.8	352896.2	332756.1
6	1108	722461	1962972.2	3891326.6	331868.6	318965.2	359767.7	349957.4
7	1699	662694	2462135.3	4482963.3	434749.1	422539.4	480921.2	472975.6
8	1277	231123	1198023.8	2048241.2	222251.9	220564.2	265161.2	267591.9
9	819	85601	527046.4	948145.9	100600.2	106099.2	136895.9	143174.1
10	1212	83529	627643.8	1124549.0	126257.2	136144.1	179745.1	189191.9
11	1403	67292	634222.2	1157775.5	138895.1	146337.7	210868.1	222266.0
12	808	29406	354078.3	654538.2	86454.6	86987.4	136524.9	142010.4
13	924	29842	456161.7	861416.1	125079.3	124589.0	203151.0	212292.8
14	1014	18663	367940.5	780090.8	110423.4	118506.6	206801.5	228449.4
15	813	10790	280682.9	646438.1	91664.6	106530.0	186332.7	217473.3
16	366	3710	137389.4	319567.5	50833.7	65276.6	98814.7	119858.7
17	431	3113	133796.2	367399.2	49691.8	71602.1	116608.1	149987.8
18	213	1119	62362.6	191477.8	24307.3	37709.6	62749.2	83295.3
19	164	834	59354.6	200245.5	24124.8	39092.6	67482.2	90865.5
20	239	633	84730.5	354279.7	38502.5	61760.1	126400.7	169182.6
Total	19370	6719445	13226005.4	30380954.3	2676013.5	2699702.3	3628940.7	3770599.3

Note: Multiple taxpayers in a single family unit have not been aggregated.

DERIVATION OF THE 1964 SALES TAX BASE  
UNDER OUR PROPOSALS

This appendix presents in Table D-1 an estimate of the base that would be taxed under the federal retail sales tax recommended in Chapters 28 and 29. The retail sales and service trade figures shown in Tables D-2 and D-3 have been taken from 1961 census data provided by the Dominion Bureau of Statistics (DBS) and have been projected on the basis of growth in personal expenditure over the 1961-64 period as reported by DBS in National Accounts, Income and Expenditure. Other sources are provided in the notes to the tables.

Because of the lack of data we had to estimate the amount of taxable goods imported directly by users and by the purchasers for federal and municipal governments other than through retail stores. We believe this estimate to be conservative. We assume that few government purchases are reflected in the retail trade statistics compiled by DBS. No estimate has been included of provincial purchases since it is assumed that if our recommendation to tax these purchases were accepted, this change would be accompanied by a corresponding reimbursement to the provinces. Existing federal sales and excise tax collections have been eliminated in arriving at the proposed tax base presented in Table D-1.

A substantial amount of goods subject to a retail sales tax do not pass through the retail trade, so that it is difficult to estimate the sales tax base from retail trade statistics alone. Because the available statistics on sales by wholesalers, manufacturers and importers are insufficiently detailed regarding types of purchases and purposes of purchases to permit detailed estimation of the volume of purchases for consumption, we felt it necessary to check our estimate of the sales tax base by comparing it to an estimate based on sales tax revenue yields experienced by the Province of Ontario. The Ontario retail sales tax has a base that is marginally smaller than that recommended for the federal



retail sales tax. Table D-4 reconciles the estimated base given in Table D-1 with the actual Ontario yield in 1964-65. Since better international and interprovincial border enforcement would be available for a federal tax, the 1964-65 Ontario yield has been regarded as equal to what would have been produced in 1964 with additional enforcement. As Table D-4 indicates, there is only a minor discrepancy between an estimate based on the Ontario figures and the direct estimate presented in Table D-1.

TABLE D-1

ESTIMATE OF PROPOSED FEDERAL RETAIL SALES TAX BASE FOR 1964  
(millions of dollars)

Taxable retail sales - as set out in Table D-2	12,800
Taxable sales by wholesalers and manufacturers	
Estimate of taxable commercial, professional, construction, transportation and sundry equipment and supplies <u>a/</u>	710
Building materials <u>b/</u>	4,170
Taxable imports by consumers <u>c/</u>	125
Taxable government purchases <u>d/</u>	
Federal	525
Municipal	<u>100</u>
Total sales of taxable goods	<u>18,430</u>
Less: federal sales and excise tax collections <u>e/</u>	<u>1,400</u>
Proposed retail sales tax base - goods	17,030
Taxable services - as set out in Table D-3	<u>4,000</u>
Proposed retail sales tax base	<u><u>21,030</u></u>

## Notes:

- a/ Because of the lack of data it was necessary to make a very general estimate of the taxable goods purchased other than through retail establishments. Direct sales to users by manufacturers of construction equipment is a large component of these figures. Most purchases for their own use by business firms do not occur at the retail level and thus fall in this category.
- b/ Dominion Bureau of Statistics, Construction in Canada 1963-65, Table 7, Catalogue 64-201, Ottawa: Queen's Printer.
- c/ Because of the lack of data it was necessary to make a very general estimate of the taxable goods imported directly by users. This item would include imports for use by business firms of taxable commercial, transportation and construction equipment and goods imported by returning tourists.
- d/ The estimate of federal government purchases of taxable goods other than through retail stores has been taken from the following items listed in the public accounts: budgeted expenditure for standard objects, office stationery supplies, equipment and furnishings, materials and supplies, equipment acquisitions and rentals.
- e/ This figure includes the sales tax on production machinery, confections, soft drinks, drugs and other items excluded from the proposed base. Excluded is the excise tax on tobacco and wine which we recommend should be retained.

TABLE D-2

ESTIMATE OF TAXABLE RETAIL SALES DRAWN FROM 1961 CENSUS  
OF MERCHANDISING AND PROJECTED TO 1964 USING  
RATIOS OF GROWTH IN PERSONAL EXPENDITURE a/  
(millions of dollars)

	Census <u>1961</u>	Proposed Tax Base <u>1961</u>	Proposed Tax Base <u>1964</u>
Retail trade category			
Food products	4,198	—	—
Automotive group b/	4,122	3,465	4,340
Clothing, footwear and dry goods	2,405	2,405	2,800
Hardware and paints	352	352	460
Furniture and appliances, etc.	961	961	1,255
Household furnishings and supplies	491	491	575
Drugs and sundries - prescribed	126	—	—
- non-prescribed	333	333	385
Fuels	361	—	—
Flowers	58	58	65
Luggage and leather goods	24	24	28
Tobacco products	297	297	345
Newspapers, magazines and books	87	—	—
Other paper products	121	121	140
Photography equipment	65	65	85
Jewellery	168	168	220
Sporting goods	147	147	190
Alcoholic beverages	897	897	1,045
Toys and games	54	54	63
Farm machinery	77	—	—
Office and store equipment	6	6	7
Heating and plumbing supplies	32	32	42
Building materials c/	21	—	—
Miscellaneous merchandise	580	580	755
Meals and lunches	70	—	—
Repairs and services d/	543	—	—
Total retail sales	16,598	10,094	12,800

Notes:

- a/ Census data are obtained from unpublished preliminary data for estimated sales in 1961 by retail establishments, classified by commodity classes and by kind of business, both for Canada and the provinces. These data were supplied to us by the Dominion Bureau of Statistics. Growth in components of personal consumption expenditure was obtained from National Accounts, Income and Expenditures, 1964, Ottawa: Queen's Printer.
- b/ The census data for the automotive group have been reduced by \$440 million to cover provincial gasoline and motor fuel tax collections in 1961. Actual collections in the fiscal year ended March 31, 1962 were \$449.1 million. The automotive group figure has also been reduced by \$317 million to allow for trade-in allowances.
- c/ Building materials have been omitted from the retail trade base and included as a separate item on Table D-1 based on data from other sources as noted.
- d/ Repairs and services rendered by retail establishments have been included in the service category on Table D-3.



TABLE D-3

ESTIMATE OF TAXABLE SERVICES DRAWN FROM 1961 CENSUS  
OF MERCHANDISING AND PROJECTED TO 1964 USING RATIOS  
OF GROWTH IN PERSONAL EXPENDITURE a/  
(millions of dollars)

	Census <u>1961</u>	Proposed Tax Base <u>1961</u>	Proposed Tax Base <u>1964</u>
Service trades			
Barber and beauty shops etc.	143	143	
Dry cleaning	117	117	
Laundry and linen supply	94	94	
Shoe repair	23	23	
Fur and hat cleaning, repair and storage	2	2	
Valet service, pressing and repair	7	7	
Dressmakers	3	3	
Photography and photo processing	47	47	
Hotel, tourist camp and restaurant group- accommodation, liquor, supplies and sundries <u>b/</u>	1,107	1,107	
Repairs and services by retail establishments	709	709	
Meals - retail establishments <u>c/</u>	70	312	
- hotels and restaurants <u>c/</u>	<u>553</u>		
Total <u>d/</u>	<u>2,877</u>	<u>2,565</u>	3,080
Telephone and telegraph <u>e/</u>			<u>920</u>
Total			<u>4,000</u>

## Notes:

a/ Census data were obtained from Census of Merchandising, 1961 - Services, Catalogue 97-540, Ottawa: Queen's Printer.

b/ Sales by the hotel, tavern and restaurant group have been reduced by one third to provide for meals which are shown separately below. The two thirds remaining represent an estimate of liquor, accommodation, other service and sundry sales by establishments in this group.

c/ An estimated 50 per cent of meals would be exempt if an inexpensive meal exemption was provided.

d/ The tax base for 1964 for the service category is estimated to be 120 per cent of the 1961 base. This growth factor is based on National Accounts, personal expenditure on services.

e/ Based on data provided by the Dominion Bureau of Statistics.

TABLE D-4

ESTIMATE OF THE PROPOSED RETAIL SALES TAX BASE FOR 1964 BASED  
ON THE REVENUE YIELD FROM THE ONTARIO SALES TAX  
(millions of dollars)

Yield of 3 per cent Ontario tax in 1964		196
Add average 2 per cent collection commission		<u>4</u>
Gross yield of the Ontario tax in 1964		<u>200</u>
Ontario yield for each 1 per cent of tax		67
National yield imputed for each 1 per cent of tax (x $\frac{100}{39}$ ) a/		<u>171.8</u>
National base corresponding to base taxed in Ontario (171.8 x 100)		17,180
Adjustments required to obtain the proposed retail sales tax base		
List of taxable services except local telephone taxed in Ontario in 1964	3,600	
Gasoline and motor fuel b/	1,155	
Municipal and institutional consumption of construction materials and other miscellaneous provincial exemptions c/	<u>525</u> 5,280	
Less: estimate of federal sales and excise taxes included in above base d/	<u>1,400</u>	<u>3,880</u>
Estimate of proposed retail sales tax base		21,060
Discrepancy between the estimate and the direct estimate presented in Table D-1		<u>30</u>
Estimated 1964 retail sales tax base		<u>21,030</u>

## Notes:

- a/ Ontario accounts for slightly less than 39 per cent of national retail sales and slightly more than 39 per cent of producer consumption. Since the proposed retail tax would exempt most producer goods, the Ontario share of the national tax base has been assumed as 39 per cent.
- b/ The gasoline and motor fuel base has been estimated on the basis of the yield from Ontario fuel taxes in the amount of \$231 million in 1964-65.
- c/ The purpose of this estimate is to adjust on a national basis for exemptions under the Ontario tax not proposed for a federal tax. The principal components are municipal and institutional purchases of construction materials, children's clothing and other sundry items.
- d/ See note e/ to Table D-1.

## APPENDIX E

### ESTIMATE OF THE INCIDENCE OF THE PROPOSED SALES TAX AND DIRECT TAXES FOR FAMILY UNITS CLASSIFIED BY INCOME

While it would be possible to do so, we have not attempted to aggregate taxpayers into family units in the calculations underlying our estimates of the effects of our proposals upon the revenue yield and incidence of the tax system. In this appendix we provide some rough estimates of the incidence of the changes in sales tax which would result from our recommendations and also of changes which would occur in direct taxes for families with one income recipient. Our estimates are based on 1961 data.

We have estimated the incidence of the sales tax by distributing total sales tax revenues from both current and proposed taxes over income classes. This distribution is based on the manufacturer's sales tax for the current sales tax and on existing provincial retail sales taxes for the proposed retail sales tax. As is indicated in Appendix D to this Volume, the proposed retail sales tax differs most notably from the existing provincial taxes in its inclusion of services in the sales tax base. Consequently, we have adjusted our estimate of the distribution of the proposed tax to reflect the likelihood that the tax would be nearly proportional for upper income families. The estimates of revenue yield by income class and underlying data are presented in Table E-1; the resultant estimates of average sales tax payments are presented in Table E-2.

For want of data on taxpayers aggregated into family units, we have had to make some arbitrary assumptions in order to obtain estimates of the changes in sales tax and direct taxes combined. We have limited our comparisons to families with one income recipient and have assumed the average taxes paid by all such families in each income class to be the same as the average taxes paid by all taxpayers in that class. This procedure results in some biases. In each income class there are some working spouses and working children who belong to families that would be classified in a higher



income class if all incomes in the family were aggregated. Because deduction and tax credits reflecting family responsibilities would, without aggregation, generally, be claimed by the income recipient with the largest income in the family, our procedure results in some overstatement of direct taxes for the lower income classes. For higher income classes, the failure to aggregate family income results in some understatement of direct taxes.

Estimates of changes in direct taxes and sales tax combined are presented in Table E-3 for family units in each income class.

TABLE E-1

DISTRIBUTION OF 1961 SALES TAX REVENUES  
OVER BROAD INCOME CLASSES UNDER THE  
CURRENT AND PROPOSED TAX SYSTEMS

<u>Income</u>	<u>Percentages of Totals Allocable to each Income Class in 1961</u>			<u>Estimate of Total Revenue from Sales Tax in 1961</u>	
	<u>Manufacturer's Sales Tax</u> (percentage of totals)	<u>Retail Sales Tax</u> (percentage of totals)	<u>Retail Sales Tax Adjusted for Inclusion of Services</u> (percentage of totals)	<u>Current</u> (millions of dollars)	<u>Proposed</u> (millions of dollars)
Less than \$2,000	6.5	7.3	6.9	91	89
\$ 2,000 - 2,999	6.5	6.7	6.4	91	83
3,000 - 3,999	10.5	10.5	10.0	148	130
4,000 - 4,999	13.8	13.7	13.0	194	168
5,000 - 6,999	27.6	27.5	26.1	388	338
7,000 - 9,999	21.6	21.2	20.2	303	262
10,000 and over	<u>13.5</u>	<u>13.1</u>	<u>17.4</u>	<u>190</u>	<u>225</u>
Total	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>1,405</u>	<u>1,295</u>

Note: The first two distributive series (that is, percentages of totals) are from Table A-2 of W.I. Gillespie, The Incidence of Taxes and Public Expenditures in the Canadian Economy, a study published by the Commission. The third distributive series is obtained from the second, given an assumption that a retail sales tax base including services is almost proportional to disposable income for families with incomes in excess of \$7,000. The distribution of disposable income is obtained from Table A-1 of W.I. Gillespie, op. cit.

Total revenues from the current sales tax in 1961 were estimated by adding to the actual revenues for that year 11 per cent of an estimate of what the building materials base would have been in 1961; total proposed revenues were estimated as 0.922 of current revenues.

TABLE E-2

AVERAGE CHANGE IN SALES TAX FOR  
UNATTACHED INDIVIDUALS AND FAMILIES  
IN DIFFERENT INCOME CLASSES

<u>Income</u>	Number of Unattached Individuals and Families in Income Class (thousands)	Average Sales Tax Paid		Average Change in Sales Tax
		<u>Current</u>	<u>Proposed</u>	
Less than \$2,000	1,134	\$ 80	\$ 78	\$ -2
\$ 2,000 - 2,999	633	144	131	-13
3,000 - 3,999	697	212	187	-25
4,000 - 4,999	771	252	218	-34
5,000 - 6,999	1,117	347	303	-44
7,000 - 9,999	602	503	435	-68
10,000 and over	263	722	856	134
All Classes	5,217	269	248	-21

Source: Table E-1. Numbers of unattached individuals and families are from W.I. Gillespie, op. cit., Table A-4.



TABLE E-3

ESTIMATED CHANGE IN AVERAGE SALES TAX AND DIRECT  
TAXES COMBINED FOR FAMILIES IN EACH INCOME CLASS  
(dollars)

	Average Change in Taxes		
<u>Income</u>	<u>Direct Taxes</u>	<u>Sales Tax</u>	<u>Total</u>
Less than \$ 2,000	-13	-2	-15
\$ 2,000 - 2,999	-17	-13	-30
3,000 - 3,999	-24	-25	-49
4,000 - 4,999	-27	-34	-61
5,000 - 5,999	-24	-44	-69
6,000 - 6,999 )	-26		
7,000 - 7,999 )			
8,000 - 9,999	-7	-68	-81
10,000 - 14,999	+71	+134	+807
15,000 - 24,999	+142		
25,000 - 49,999	+584		
50,000 and over	+8,472		
All Classes	+14	-21	-7

Note: Average direct taxes of families in each income class have been assumed to be the same as the average taxes attributable to all taxpayers in the income class. Direct taxes of taxpayers with incomes between \$6,000 and \$7,999 have been allocated on the assumption that 45 per cent of these taxpayers have incomes between \$7,000 and \$7,999.

Sources: Tables 36-4 and E-2.



## I N D E X

### A

ABATEMENTS, provincial tax, 189-191, 219.

ADMINISTRATION, federal-provincial relations, 188, 194-195, 214.

AGRICULTURE, *see* FARMERS.

ALBERTA, provincial sales tax, 209, 211.

ATTORNEY-GENERAL OF NOVA SCOTIA *et al.* V. ATTORNEY-GENERAL OF CANADA, 205.

AVERAGING, *see* INCOME AVERAGING.

AVOIDANCE OF TAX, effect on corporation tax base of reducing tax avoidance, 9.

### B

BALANCE OF PAYMENTS, effects of tax reforms, 155-164, 174-175; effects of tax reforms on the current account, 156-158, 174; effects of tax reforms on capital flows, 158-162, 174-175; indirect effects of tax reforms, 162-164, 174-175.



BANK OF CANADA, 148.

BENEFITS, from employment, effect of reforms on personal income tax base,  
14-17.

BRITISH COLUMBIA, death taxes, 202.

BRITISH NORTH AMERICA ACT, 204, 205, 207, 210, 216.

BUSINESS INCOME, effect of reforms on amount included in personal income  
tax base, 22; effects of reforms on tax revenues, 266.

BUSINESS LOSSES, inadequacy of present allowance, 89; effect of reforms on  
the allocation of capital, 91.

## C

CAPITAL ALLOCATION, effects of proposed tax reforms, 86-94, 170; efficiency  
of market allocation, 87-88; a programme to improve the allocation of  
capital, 90-93; the importance of the improved allocation of fixed  
capital, 93-94.

CAPITAL COST ALLOWANCES, effect on corporation tax base of accelerated  
allowance for new and small businesses, 9; effect on personal income  
tax base of accelerated allowances for new and small businesses, 15-17;  
transitional effects of proposals on tax revenues, 35-36, 40; as  
incentives to investment, 92, 167-168.

CAPITAL EXPENDITURES, effect of proposed corporation income tax changes, 96,  
100; effect of proposals on expenditures of corporations with special  
concessions, 118-119, 172; by smaller corporations, effects of proposals  
on financing, 147.

CAPITAL FORMATION, see also SAVING; by corporations, effect of proposals,  
94-133, 171-173; estimates of the proposed corporation income tax

changes allocated by industry, by type of reform and by ownership, 94-100; effects on the rate of saving and capital formation by large resident-owned corporations with no special tax concessions, 100-118, 171; effect on the rate of fixed capital formation, 106-111; financing an increased rate of fixed capital formation, 111-118; effects on the saving and capital formation of other businesses, 118-128; effects on large non-resident-owned corporations with no special tax concessions, 118-119, 171-172; effects on mining and petroleum corporations, 119-125, 172; effect on small corporations, 125-127, 172; effect on unincorporated businesses generally, 127-128, 172; estimates of changes in business saving, 129-133, 173; overall effects of proposals, 150-155.

CAPITAL GAINS, see PROPERTY GAINS.

CAPITAL MARKET, as determinant of capital allocation, 86-88.

CHARITABLE DONATIONS, effect of reforms on personal income tax base, 20-21, 243.

COMBINES POLICY, use to correct distortions of allocation of capital, 90, 170.

COMPREHENSIVE TAX BASE, effect of proposals on amount of income assessable, 1-2, 8-22; tax changes for "example groups" of taxpayers arising from adoption of, 54.

CONCESSIONARY ALLOWANCES, effect of reforms on personal income tax base, 19-22, 242-243; effect of reforms on "example groups" of taxpayers, 52-55; effects of reforms on tax revenue, 266.

CONCLUSIONS AND RECOMMENDATIONS, see RECOMMENDATIONS.

CONSTRUCTION INDUSTRY, estimated changes in corporation income tax and capital expenditures, 96-97; effects of reforms on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

CO-OPERATIVES, estimated changes in corporation income tax and capital expenditures, 96-97.

CORPORATION INCOME TAX, the effect of our reforms on 1964 revenues from, 4, 8-13, 32, 42-43, 221-223; current and proposed attributable to shareholders, by industry, 51; effect of reforms on "example groups" of taxpayers, 53, 263-266; effect of separate corporation tax on the allocation of capital, 89; proposed integration with personal income tax, 91; estimates of changes, allocated by industry, type of reform and ownership, 94-100; effects of reforms on the capital formation and rate of saving by corporations, 100-133; need for determination by federal government, 189, 214.

CORPORATIONS AND LABOUR UNIONS RETURNS ACT, 224, 231.

CREDITS, tax, effect of reforms on personal income tax revenues, 23-28; for education, 85-86; for corporation income taxes, effects on after-tax income of resident shareholders, 101; for investment, use to provide tax incentives, 167-168; for provincial corporation taxes, 191-193, 197, 214.

CROWN CORPORATIONS, estimated changes in corporation income tax and capital expenditures, 96-97.

## D

DEATH TAXES, abolition of, 201-202.

DEPENDANTS, effect of proposals for credits on personal income tax revenues, 23-28; estimate of exemptions for, 242; estimated number, 244.

DEPLETION ALLOWANCES, effect of withdrawal of percentage depletion on mining and oil companies, 9, 119, 172; basis for estimate of deduction by taxpayers with income from mining and petroleum, 221.



DEPRECIATION, see CAPITAL COST ALLOWANCES.

DIVIDENDS, effect of proposals on cash dividends, 129, 173; effect of expected cash dividend reduction on personal saving, 142, 173; distributed to residents and non-residents in 1964, 223-229.

DOMINION BUREAU OF STATISTICS, 30, 275.

DONATIONS, see CHARITABLE DONATIONS.

DOUBLE TAXATION, by federal and provincial governments, 193, 200, 215.

## E

ECONOMIC EFFECTS OF PROPOSALS, general, 73-186; on the quantity and quality of labour effort, 78-86, 169-170; on the allocation of fixed capital, 86-94, 170; a programme to improve the allocation of capital, 90-93; the importance of the improved allocation of fixed capital, 93-94; estimates of the proposed corporation tax changes allocated by industry, type of reform and ownership, 94-100, 170; effects on the rate of saving and capital formation by large resident-owned corporations with no special tax concessions, 100-118, 171; effects on after-tax income of resident shareholders, 101-106, 171; effect on the rate of fixed capital formation, 106-111, 171; financing an increased rate of fixed capital formation, 111-118, 171; on non-resident-owned corporations, 118-119, 171; mining and petroleum corporations, 119-125, 172; small corporations, 125-127, 172; unincorporated businesses, 127-128, 172; real estate, 128, 172; estimates of changes in business saving, 129-133, 173; effects on personal saving and investment, 134-136, 173-174; determinants of personal saving, 134-136; the effects of tax changes on the rate of personal saving, 137-139, 173-174; contractual saving, 140-141; estimates of the changes in the rate of personal saving, 141-146, 173-174; changes in the form of personal saving, 146-150, 173-174;

overall effects on the rate of saving and investment, 150-155, 174;  
 effects of the tax reforms upon the balance of payments, 155-164,  
 174-175; implications for economic objectives, 164-168, 175.

ECONOMIC GROWTH, implications of tax reforms, 164-168, 175; achieving  
 further increases in the growth rate, 166-168, 175.

EDUCATION, effect of proposals on personal income tax base, 20-21; effects  
 of proposed credits for on personal income tax revenues, 23-28; tax  
 concessions for, 85-86, 169.

EMIGRATION, tax inducements to emigrate to the United States, 81-82, 169.

EMPLOYEE EXPENSES, effect of proposals on personal income tax base, 15-17.

EMPLOYMENT INCOME, effect of proposals on amount included in personal  
 income tax base, 22; effects of proposals on tax revenue, 266.

ESTATE TAX, the effect of our proposals on 1964 revenues from, 4, 42-43.

EXCISE TAXES, the effect of our proposals on 1964 revenues from, 4, 42-44;  
 reconciliation of 1964 revenues under actual 1964 law and 1966 law, 7.

EXEMPTIONS, for new mines, effect on corporations of elimination, 9, 119,  
 172; effect of proposals on personal income tax base, 19-22; for new  
 mines, effect of transitional provisions on tax revenues, 38; esti-  
 mates, source of, 242-243.

EXPLORATION AND DEVELOPMENT COSTS, effect of transitional provisions on  
 tax revenues, 38-39; immediate write-off to be continued, 92.

EXPORTS, effects of tax reforms, 156-158.

EXTRACTIVE INDUSTRIES, see MINING AND PETROLEUM.

## F

FAMILIES, effect of proposals on tax revenues, 26-28, 266.

FARMERS, effect of proposals on amount included in personal income tax base, 22; estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures, and reliance on external funds, 131.

FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS ACT, 190.

FEDERAL-PROVINCIAL RELATIONS, implications of our recommendations, 187-217; similarity of income tax bases, 187, 214; the principle problem, 187; adoption of a common retail sales tax base, 187, 214; avoiding duplication of administrative and compliance costs, 188; the effect of the drive for provincial autonomy, 188; major considerations, 188-190; resisting further personal income tax abatements, 189; determination of income tax bases, 189, 214; redistribution of personal income, 189, 214; tax cuts to offset the revenue drag, 190; personal and corporation income taxes, 190-202, 214; abatements for provincial tax, 190; "opting-out" formula, 190-191; tax credit for provincial taxes, 191-193, 214; rates of tax on corporate income, 192; double taxation of business income, 193, 215; advantages of common income tax base, 193-194; administration of income taxes, 194-195, 214; integration of personal and corporation income taxes, 195-197, 214; harmonization of rates of personal and corporation income taxes, 197-201, 214; double taxation of personal income, 200, 215; abolition of death taxes, 201-202; sales taxes, 202-217; the scope or coverage of the sales tax, 203-204, 215; "direct" or "indirect" retail sales tax, 204-205; constitutional considerations with respect to sales taxes, 205-207, 215; sales tax on interprovincial transactions, 208-209; administration of a federal-



provincial retail sales tax, 209-210, 215; termination of manufacturer's sales tax, 210, 215; rates of sales tax, 210-213, 215; recommendations, 213-215.

FINANCE INDUSTRY, estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

FINANCIAL INSTITUTIONS, see also LIFE INSURANCE COMPANIES; additions to corporation tax base resulting from removal of tax concessions, 8-9; transitional effects of proposals on tax revenues, 36; current and proposed corporation income taxes, 51; effect on capital allocation of present special industry privileges, 90.

FINANCING, for an increased rate of fixed capital formation, 111-118, 171; methods of, effect of proposals, 147.

FISHERMEN, effect of proposals on amount included in personal income tax base, 22.

FISHING, estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

FOREIGN INVESTMENT, effects of tax reforms, 158-162, 174-175.

FOREIGN TAX CREDIT, effect of proposals on personal income tax revenues, 23-28.

FOREIGN TRADE, effects of tax reforms, 156-158.

FORESTRY, estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

## G

GIFT TAX, the effect of our proposals on 1964 revenues from, 4, 32, 42-43;  
effect of proposals on "example groups" of taxpayers, 52-55.

GIFTS, effect of proposals on personal income tax base, 14-17; inclusion  
in personal income tax base, the effect of provincial death taxes, 188;  
inclusion in comprehensive tax base of provinces, 202.

GOODWILL GAINS, amounts attributable to Canadian residents for 1964, 11;  
effect of proposals on after-tax income of resident shareholders,  
101-106; data with respect to, 226.

GROWTH, economic, see ECONOMIC GROWTH.

## I

IMPORTS, effects of tax reforms, 156-158.

INCENTIVES, tax, see TAX INCENTIVES.

INCIDENCE, of tax, see TAX INCIDENCE.

INCOME AVERAGING, effect of proposals on personal income tax revenues, 27-28.

INCOME TAX REGULATIONS, rules for abating personal income taxes, 191.

INHERITANCES, inclusion in comprehensive tax base of provinces, 202.

INSURANCE INDUSTRY, estimated changes in corporation income tax and capital  
expenditures, 96-97; effects of proposals on corporation cash flows,  
cash dividends, capital expenditures and reliance on external funds, 131.

INTEGRATION OF TAX, effect of proposals on personal income tax base, 15-17;  
effect on "example groups" of taxpayers, 52-55; economic implications  
of, 99; effect of proposals on after-tax income of resident

shareholders, 101-106, 171; personal and corporation income taxes, federal-provincial relations, 195, 214.

INVESTMENT, foreign, see FOREIGN INVESTMENT: overall effects of proposals, 150-155, 174.

INVESTMENT INCOME, effect of proposals on personal income tax base, 14-18.

INVESTMENT TAX ON BUSINESS, use of, 167-168.

## L

LABOUR SUPPLY, effects of proposals, 78-86, 169-170; effect of lower tax rates, 79-81, 169; tax inducements to emigrate to the United States from Canada, 81-82, 169; the participation rate for married women, 82-84, 169; education and training, 84-86, 169.

LIFE INSURANCE COMPANIES, effect on corporation tax base of elimination of special provisions, 9; current and proposed corporation income taxes, 51; effect of proposed treatment of business income, 95-100; effect of recommended treatment for income, on after-tax return of resident shareholders, 105; investment income and participating dividends of policyholders, 237.

LOSS CARRY-OVERS, effect on corporation tax base of extending carry-over periods, 9; effect of proposals on personal income tax base, 15-17.

LOSSES, see BUSINESS LOSSES and LOSS CARRY-OVERS.

## M

MANITOBA, rates of tax, 190; provincial sales tax, 209, 211.



MANUFACTURING INDUSTRIES, estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

MARRIED WOMEN, see also WORKING WIVES, participation in the labour force, 82-84, 169.

MEDICAL EXPENSES, effect of proposals on personal income tax base, 20-21, 243.

MINING AND PETROLEUM, addition to corporation tax base resulting from removal of tax concessions, 8-9; current and proposed corporation income taxes, 51; effect on capital allocation of present special industry privileges, 90; elimination of favourable treatment, effect on capital allocation, 91-92; the marginal tax rate for mining corporations, 94; effect of withdrawal of tax concessions on business saving and investment, 95-100, 118-125, 172; effects of proposals on fifteen large mining and petroleum corporations, 120-122; effects of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

MOTHERS, working, see WORKING WIVES.

MUNICIPAL TAXES, see PROPERTY TAXES.

## N

NET WEALTH TAX, possible use of, 40; as supplemental tax for provinces, 201.

NET WORTH TAX, see NET WEALTH TAX.

NEW AND SMALL BUSINESSES, see also RISKY VENTURES; effect of accelerated write-off of capital costs, 93, 126, 172.

NON-RESIDENTS, effects of changes in corporation income taxes, 10, 12, 47, 50-51, 69, 98; effects of proposals on shareholders of Canadian corporations, 118-119; reaction of portfolio investors to proposals, 149.

O

OIL INDUSTRY, see MINING AND PETROLEUM.

ONTARIO, collection of taxes, 195; death taxes, 202.

P

PAYMENT OF TAX, transitional effect of proposals on tax revenues, 36.

PENSIONERS, effect of proposals, 55.

PERMANENT ESTABLISHMENT, effect on income tax abatement and credits, 191-193.

PERSONAL INCOME TAX, see also INTEGRATION OF TAX; the effect of our proposals on 1964 revenues from, 4, 13-28, 32, 42-44; reconciliation of tax under 1966 law to actual amounts accrued under 1964 law, 5; effect of proposals on tax base, 13-22; effect of proposals on tax revenues, 23-28, 42-43; proposed integration of corporation income tax, 91.

PROPERTY GAINS, effect of proposals on corporation tax base, 9; effect of proposals on personal income tax base, 14-17; transitional effects of proposals on tax revenues, 34; effect of failure to tax on capital allocation, 89; proposed taxation, effect on capital allocation, 91; effect on corporations of proposed full taxation of, 95; effects of reforms on tax revenue, 266.

PROPERTY TAXES, reducing relative importance, 189.

PROVINCES, see also FEDERAL-PROVINCIAL RELATIONS: net worth tax as possibility, 201; tax abatements to in 1964, 219.

PROVINCIAL TAX ABATEMENTS, see ABATEMENTS.

## Q

QUEBEC, rates of tax, 190; administration of certain welfare programmes, 191; collection of taxes, 195; death taxes, 202; registration requirement for firms soliciting business in the province, 208.

## R

RATES OF TAX, effect of proposals on revenue, 2, 44, 266; effect of proposals on average rate of corporate taxation, 10; changes in tax for "example groups" of taxpayers caused by reductions in personal income tax rates, 54; average effective rates for individuals, present and proposed, 56, 58; effects of lower marginal rates on labour supply, 79-81, 169; inefficiency of present dual rate of corporation tax, 89; elimination of dual corporate rate, effect on capital allocation, 92; marginal rates for corporations, effect on capital allocation, 94; effect of withdrawal of dual corporate rate, 95-100; proposed, effects on after-tax income of resident shareholders, 101; present corporate rates, 192; harmonization of rates of personal and corporation income taxes, federal-provincial implications, 197-201, 214; sales taxes, 210-213, 215.

REAL ESTATE, effects of proposals, 96-97, 128, 131.

RECOMMENDATIONS, federal-provincial relations, 213-215.

REFUNDS, of federal tax, application to provincial tax, 196.

REGISTERED RETIREMENT INCOME PLANS, effect of recommended treatment of corporate source income, 105; expected increase in investment in equities, 148; use of proposed provisions to provide tax incentives, 167-168; effect of deferring tax on corporation income paid or attributable to, 225-226.



RESEARCH AND DEVELOPMENT, immediate write-off of costs to be continued, 92.

RESOURCE INDUSTRIES, see MINING AND PETROLEUM.

RETAILERS, effects of proposals, 96-97, 131.

RETAINED EARNINGS, changes in, due to proposed tax treatment, 129-133.

RETIREMENT INCOME PLANS, see also REGISTERED RETIREMENT INCOME PLANS;

proposed changes in taxes paid on retirement income plan investments,  
for "example groups" of taxpayers, 53.

REVENUE DRAG, tax cuts to offset, 190.

REVENUES, FEDERAL, effects of our proposals upon the revenue yield of the tax system, 1-46; the long-term effect of our recommendations on tax revenues, 2-30, 42-43; definition of 1964 tax under current system, 3-8; changes in tax revenues collected at the corporate level, 8-13, 42; changes in the personal income tax base, 13-22; changes in personal income tax revenues, 23-28, 42; changes in sales tax yields, 27-30, 42; analysis of the revenue effect of each major reform, 31-32, 43; transitional effects of our recommendations on tax revenues, 33-42, 44; short-term and long-term impacts of our recommendations, 33-37; revenue effects of transitional provisions, 37-39, 44; alternative approaches to the transitional problem, 39-42; effects of proposals, summary and conclusions, 42-44; the long-term elasticity of the proposed tax system, 43; distribution of proposed changes on the weight of taxes on individuals, 47-70; from retail sales tax, 211; reconciliation of the actual amount of personal income tax revenue for 1964 to the revenue that would have resulted in 1964 under current (1966) tax law, 219; assumptions underlying estimates, 219-245; changes in the 1964 corporation tax base, 221-223; corporate source income attributable to resident individuals in 1964, 223-229; changes in 1964 taxes accrued at the corporate level as a result of our proposals, 230; the effect of

particular reforms on each component of the gross personal income tax base for 1964, 232-241; increase in the personal income tax base as a result of particular reforms in concessionary allowances and family exemptions deducted in computing taxable income, 242-243; tax credits applicable to personal income taxes for residents in 1964, 244; total personal income taxes under the current and proposed tax systems, 244-245; proration of the effects of each direct tax reform, 263-266.

RISKY VENTURES, see also NEW AND SMALL BUSINESSES; capital market bias against, 87-88.

## S

SALES TAX, the effect of our proposals on 1964 revenues from, 4, 29-30, 32, 42-44, 47, 275-280; reconciliation of 1964 revenues under actual 1964 law and under 1966 law, 7; transitional effects of proposals on tax revenues, 33; effect of transitional provisions on tax revenues, 38; incidence of changes in, 67, 281-285; reducing relative importance, 189; federal-provincial consultation required, 189, 213; federal-provincial implications of recommendations, 202-213, 215; manufacturer's level, termination, 210, 215.

SALES TAX, RETAIL LEVEL, effect of proposals on sales tax revenue, 2, 42-43; adoption of a common base, federal-provincial implications, 187, 203-204, 214, 215; "direct" or "indirect", 204-205; estimates of proposed base, for 1964, 280; estimates of incidence, 281-285.

SASKATCHEWAN, rates of tax, 190.

SAVING, see also CAPITAL FORMATION; economic effects of proposals on the rate of business savings, 129-133, 173; effect of proposals on personal saving, 134-150, 173-174; determinants of personal saving, 134-136; the effects of tax changes on the rate of personal saving, 137-139, 174;

estimates of the changes in the rate of personal saving, 141-146; changes in the form of personal saving, 146-150, 173-174; overall effects of proposals, 150-155, 174.

SERVICE INDUSTRY, estimated changes in corporation income tax and capital expenditures, 96-97; effect of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

SHARE GAINS OR LOSSES, proposed taxation of gains, effect on capital allocation, 91.

SHAREHOLDERS, effects of proposals on resident shareholders, 101-118, 171; resident, of non-resident controlled corporation, 118; non-resident, effects of corporation income tax proposals, 118; of mining and petroleum companies, effect of integration proposals, 122, 172.

SUBSIDIES, by provinces to businesses, 196.

## T

TAX CONCESSIONS, revenue effect of removing from specific industries, 8; effect on capital allocation, 90; mining and petroleum, effect of withdrawal of, 95, 172; effects on the tax reforms proposed, 167-168.

TAX INCIDENCE, of the proposed system, 47-70; of changes in direct taxes, 49-68; of changes in direct taxes on non-residents, 50; of changes in direct taxes, on typical Canadian residents, 52-55; of changes in direct taxes, by income class for Canadian residents, 56-62; of changes in direct taxes, by income class for different age, occupation and sex groups, 63-66; of changes in sales taxes, 67; of changes in all taxes combined, 67-68; of proposed system, conclusions, 69-70; reconciliation of the actual amount of personal income tax revenue for 1964 to the revenue that would have resulted in 1964 under current (1966) tax law, 219;



assumptions underlying estimates, 219-245; changes in the 1964 corporation tax base, 221-223; corporate source income attributable to resident individuals in 1964, 223-229; changes in 1964 taxes accrued at the corporate level as a result of our proposals, 230; the effect of particular reforms on each component of the gross personal income tax base for 1964, 232-241; increase in the personal income tax base as a result of particular reforms in concessionary allowances and family exemptions deducted in computing taxable income, 242-243; tax credits applicable to personal income taxes for residents in 1964, 244; total personal income taxes under the current and proposed tax systems, 244-245; estimate of sales tax and direct tax for family units classified by income, 273-277.

TRANSFER PAYMENTS, effect of proposals on personal income tax base, 15-17.

TRANSITION TAX, on corporate source income, 40.

TRANSITIONAL PROVISIONS, effects on tax revenues, 37-39, 44.

TRANSPORTATION INDUSTRY, estimated changes in corporation income tax and capital expenditures, 96-97; effects of proposals on corporation cash flows, cash dividends, capital expenditures and reliance on external funds, 131.

TRUSTEES, current and proposed corporation income taxes, 51.

## U

UNEMPLOYMENT, effect on emigration, 82.

UNEMPLOYMENT INSURANCE, estimated benefits under, 232.

UNITED STATES, tax inducements to emigrate to, 81-82, 169; differences among state income taxes, 193; taxation of property gains and losses, and revenue therefrom, 233-236.

## W

WEALTH, see NET WEALTH TAX.

WHOLESALERS, estimated changes in corporation income tax and capital expenditures, 96-97; effects of proposals on corporation cash flows, cash dividends, capital expenditures, and reliance on external funds, 131.

WORKING WIVES, effect of proposed credit on personal income tax revenues, 23-28; estimated credits, 244.

WORKMEN'S COMPENSATION, estimated benefits under, 232.













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